No. 12073

In the United States
COURT OF APPEALS
for the Ninth Circuit

J. W. MALONEY, United States Collector of Internal Revenue for the District of Oregon,

Appellant,

v.

ROSS B. HAMMOND,

Appellee.

On Appeal from the United States District Court for the District of Oregon.

BRIEF FOR THE APPELLEE

FILED

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SUBJECT INDEX

SUBJECT INDEX (Cont.)

TABLE OF STATUTES AND REGULATIONS

TABLE OF CASES AND TEXTS

TABLE OF CASES AND TEXTS (Cont.)

TABLE OF CASES AND TEXTS (Cont.)

TABLE OF CASES AND TEXTS (Cont.)

TABLE OF CASES AND TEXTS (Cont.)

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STATEMENT OF THE CASE

On July 27, 1945, the Commissioner of Internal Revenue assessed against appellee a deficiency in income and surtaxes for the taxable year 1943 involving the consolidated return for the tax years 1942 and 1943 (necessitated by the forgiveness tax act), in the sum of $157,146.90 principal and interest.

The deficiency was predicated on two grounds:

1. Denial of the existence of the partnership between appellee and his son William;

2. Denial that appellee had the right to adopt and inaugurate the accrual method of accounting in the tax years in question, and that he should have kept his accounts and reported income on the "percentage of completion" basis.

Appellee paid the tax and brought this action for refund.

Both issues were decided in the court below adversely to the Commissioner. The partnership issue has been abandoned by appellant on this appeal.

With respect to the issue involving the accounting method, there is no issue of fact as to amount of "gross income" accrued and reported and the "deductions" accrued and reported in each tax year. The issue involves only the method of **computing** the "net income" therefrom for each tax year.

More than a year and a half after the action was commenced, and fifteen months after the answer was filed, appellant attempted to introduce a **set-off** against the claim for refund by a motion for leave to file an amended answer setting up the alleged set-off against the cause of action set forth in the complaint.

The claim sought to be set off was not based on the determination and assessment of any deficiency.

The motion was opposed on the ground, among others, that the claim sought to be set up as a set-off was barred by the Statute of Limitations.

An order was entered denying the motion; **no appeal was taken from that order.**

Upon the trial appellant offered evidence in support of the set-off; objection was seasonably interposed. The court below permitted the evidence to be introduced "subject to objection".

The court below made findings of fact and conclusions of law in favor of the appellee on all of the issues, including the issue involved in the tendered set-off.

Appellant appealed from the judgment entered thereon and now seeks a review of the order denying the motion to interpose the set-off.

Appellee contends that this court is without jurisdiction to review the said order because it was appealable. No appeal was taken therefrom, and the time for an appeal expired prior to the taking of the appeal from the judgment. The notice of appeal does not refer to said order.

Assuming without admitting that the assignment of errors was sufficient for that purpose, appellee contends that the only reviewable questions are,

(a) Was appellee authorized to adopt the accrual method of accounting?

(b) Did the method employed "clearly reflect the income"?

(c) Was the method adopted by the Commissioner authorized by the Internal Revenue Act and Regulations?

Findings of Fact and Conclusions of Law are set forth in full at pages 19 to 39 of the Transcript of Record.

The pertinent Statutes and Regulations are set forth at pages 101 to 107 of Appendix.

I.

RE: ASSIGNMENT OF ERROR THAT THE DISTRICT COURT ERRED IN ACCEPTING TAXPAYER'S METHOD OF ACCOUNTING AND REJECTING COMMISSIONER'S

SUMMARY

a.

The assignment of error is insufficient to present any issue for consideration by the court, in that it does not set out "separately and particularly each error intended to be urged" and it does not state "as particularly as may be wherein the findings of fact and conclusions of law are alleged to be erroneous" (Rule 20 (d) of this court).

b.

The question of the proper method of accounting is one of fact. It is not the province of this court to try this case **de novo.** The findings of fact are presumptively correct and may not be set aside unless clearly erroneous. If the findings are sustained by substantial evidence they cannot be held to be clearly erroneous.

c.

All of the findings of fact, including the finding that appellee's method of accounting "clearly reflects the income", are supported by great preponderance of the evidence, and they sustain the conclusions of law. Indeed with a few inconsequential exceptions, appellee's evidence is uncontradicted.

d.

The Commissioner did not change any figure of annual "gross income" (Sec. 22), or annual "deductions" (Sec. 23). He only allocated (retrospectively) the accumulated three years total "net income" (Sec. 21) by arbitrarily allocating a percentage of the accumulated three year total of "net income" to each year, in violation of Sec. 21 of the Internal Revenue Code.

e.

If an error is made in reporting a particular item of "gross income" or "deduction" it does not authorize rejection of the accrual method of accounting; it only requires an adjustment of that particular item within the framework of the ac-

crual system. The Commissioner did not challenge any particular item. He only challenged the right to adopt the accrual method at all, and contends that the taxpayer should have adopted the "percentage of completion method".

> **U. S. v. American Can Co., 280 U.S. 412; 50 Sup. Ct. 177, 179.**
> **Bartles Oil Co. v. Commissioner, 2 B.T.A. 16;** Appendix p. 117.
> **Sneed v. Commissioner, 119 Fed. (2d) 767, 771 (5th Cir.);** Appendix p. 118.
> **Merton's Law of Fed. Income Taxation, Vol. 1, page 493, Sec. 11.14;** Appendix p. 119.

f.

The Internal Revenue Code and the regulations give to the taxpayer the absolute right to adopt any method of accounting which he deems suitable to his business, subject only to the condition that such method clearly reflect the income. A contractor engaged in the construction of buildings and structures which may extend over a period of more than one taxable year has the option to adopt (a) cash method, (b) accrual method, (c) percentage of completion method, or (d) completion of contract method. These are distinct methods. He has no right, and he cannot be compelled to adopt a "hybrid" method composed in part of each of the said four methods. The method adopted must be consistently maintained.

g.

A method of accounting that "clearly reflects the income" is one in which the books are "kept

fairly, honestly, straightforwardly and frankly," as distinct from "accurately or without error or defect". When so kept, the books are controlling, unless there has been an attempt of some sort to evade the tax.

Osterloh v. Lucas, 37 Fed. (2d) 277 (9th Cir.).
Huntington Securities Corp. v. Busey, 112 Fed. (2d) 368, 370 (6th Cir.), citing with approval the Osterloh case.
Welch v. DeBlois, 94 Fed. (2d) 842 (1st Cir.).

h.

The term "clearly reflect the income" does not refer to the income in any "given year". It refers to the total income "over a period of years growing out of and in some way related to an initial transaction in the taxable year."

Security Flour Mills Co. v. Commissioner, 321 U.S. 281; 64 Sup. Ct. 596, 599.

i.

If the taxpayer's method of accounting clearly reflects the income, the statute is "mandatory" on both the taxpayer and the Commissioner that taxable income must be determined in accordance therewith.

Huntington Securities Corp. v. Busey, 112 Fed. (2d) 368, 370 (6th Cir.).
Rowe v. Commissioner, 7 B.T.A. 903-908.
Coatesville Boiler Works v. Commissioner, 9 B.T.A. 1242.
Index Notion Co. v. Commissioner, 3 B.T.A. 90.

j.

A taxpayer who is engaged in the performance of long-term contracts is not compelled to adopt the "percentage of completion" method of accounting. He may do so at his option.

Regulation 111, Sec. 29.42-4, p. 260; Appendix p. 105.
Orino v. Commissioner, 34 B.T.A. 726.

k.

Appellee, who maintained his accounts on the accrual method, was not required to carry any record of inventories, prepaid expense or work in progress because (a) the Internal Revenue Code and regulations do not require such records, and (b) the findings of fact supported by substantial evidence established that appellee did not have any stocks of merchandise or materials on hand or work in progress to be recorded in such records.

l.

The method of accounting employed by the Commissioner in determining the deficiency was a hybrid, illegal and concededly "retrospective" method of accounting, and it is admitted (Brief, p. 17) that it is not "explicitly provided for by the Regulations nor by the Internal Revenue Code". The determination of a deficiency and the assessment based thereon were therefore illegal.

ARGUMENT

Statement of Facts Pertaining to Accounting Method.

Appellee's income was derived from public works contracts entered into with government agencies for the construction of buildings and other public works. The contracts were, generally speaking, of three types: (a) lump sum contracts; (b) cost plus percentage contracts; (c) cost plus fixed fee contracts and one contract in which the government agency agreed to pay a fixed amount per cubic yard of cement work to cover all costs for all materials, labor and supervision supplied.

All contracts made provision for periodic (monthly) payments on "estimates" approved by the engineer or other official designated in the contract for that purpose.

All contracts made provision for retention of a fixed percentage of the amounts determined by the estimates to insure faithful performance of the contracts.

There was some variation (not material) in the terms of the retained percentage provisions. In the main they provided for retention of a fixed percentage of the determined amount of labor and material **incorporated** into the structure and a different fixed percentage of the amount of the **materials not incorporated** into the structure.

Monthly "estimates" were made as follows: The superintendent in charge of a particular job would figure up how much appellee was entitled to receive. The figures were then submitted informally to the engineer or architect in charge and were gone over with him. When they reached an agreement a formal statement was prepared and submitted, upon which the official in charge issued the requisite certificate. Appellee's bookkeepers then prepared an invoice for the total amount found to be due to the appellee. The invoice together with supporting documents and certificate were forwarded to the proper channels for payment (Tr. 155 to 157, 233).

The invoices were issued for 100% of the amounts found to be due, without deduction for the retained percentages. These deductions were taken when payment was made.

When the invoices were issued, the amount thereof was entered on the books of the appellee in two accounts; one account recorded the amount that was **presently payable** and the other recorded the amount of the retained percentages, payment of which was deferred until completion as an "account receivable" (Tr. 279, 287, 288).

In making up the monthly "estimates" and invoicing, it was the policy to include as much of the labor and material as could possibly be legally included, so that the maximum payments could be obtained (Tr. 162, 176, 233). This was the prac-

tice that was uniformly followed (Tr. 162).

In one or two instances controversies arose between the appellee and the officer in charge, as to whether a certain piece of work had been completed in accordance with the contract. In those instances the officer refused to issue the requisite certificate and appellee was unable to render any invoice for payment, and hence did not enter on his books the amount that was deemed to be owing until the controversy was terminated and appellee became entitled to the issuance of an engineer's certificate (Tr. 168). The "estimate" would then be submitted, certificate obtained, invoice issued, and the amount would then be accrued on the books.

The Milwaukie Housing Project, Job No. 207 (Revenue Agent's report, Exhibit "20", Tr. 612, first line) is an illustration. The contract had been fully completed in 1942 according to appellee's version and he would have been entitled to receive approval of the payment of $7634.09. The engineer, however, questioned the compliance with the contract and refused to issue the certificate in 1942 until certain corrections were made. These corrections were made in 1943, at a cost of $575.12, whereupon the engineer approved the work and issued the certificate, which enabled the contractor to render an invoice for the sum of $7634.09, and at that time accrued that amount on the books as income. The cost of that project (except $575.12 expended in 1943) was accrued in 1942 when the expense was incurred. The $575.12 was accrued as

an expense in 1943. The $7634.09 could not be accrued as income in 1942 because without the engineer's certificate, appellee did not have the "right to receive" that sum under the contract. The government did not become liable until 1943 when the certificate was issued and an invoice could be rendered (Tr. 168, 169). All of the billing or invoicing was made and the amounts accrued on the books on the "estimates" approved by the engineers in charge (Tr. 203, 204, 205, 233).

All expense was accrued at the time it was incurred and the "obligation to pay" the same became fixed. The income was accrued when the "right to receive" payment became fixed by the issuance of the engineer's certificate (Tr. 247, 249, 278).

The books of account were kept on the accrual basis (Tr. 272). There was set up on the books all of the accounts usual and necessary to an accrual system of bookkeeping (Tr. 275, 276, 393). They were (Tr. 343), "accounts payable," "accounts receivable," "accrued expense," "accrued Federal Social Security," "accrued unemployment compensation," "accrued interest payable," "accrued payroll," "accrued taxes," "notes payable," "bonuses payable," "and other accounts of this type."

The returns were made from the books as so kept (Tr. 277, 278). When an "estimate" was not approved no billing could be made and the amount was not entered in the books (Tr. 315). Materials

that were on hand and not yet incorporated were included in the "estimates" (Tr. 340).

Mr. Garthe Brown, an accountant, testified that he had examined the books of account; that the books were kept on a true accrual basis (Tr. 349); that they clearly reflect the "income" (Tr. 351); that under the accrual method as applied to a contractor no inventory account or work in progress account was necessary (Tr. 353, 380); that the accounts were kept according to good accounting practice (Tr. 354, 381); that under Mr. Williams' (Revenue Agent) method of accounting a taxpayer could never make a return at the end of a tax year, but would have to wait until the end of the completion of the contract and go back three years and recompute the profits (Tr. 381).

Mr. Frank Eiseman, a certified public accountant, testified that he had examined the books of account of appellee; that the method employed was consistently followed during the years 1939 to 1944; that the method employed was an accrual method (Tr. 392, 393), and that the books contained all of the accounts appropriate to an accrual method.

He examined the income tax returns and found that they were made in accordance with the accounts as they were kept (Tr. 393). He found that the books "clearly reflect the income" within the meaning of the Internal Revenue Code and Regulations (Tr. 394). He found that all billings were

based on the engineer's "estimate" attached to the billings (Tr. 396); the profits were reflected on the books on the strict accrual method of accounting (Tr. 396). On a percentage of completion basis inventories have to be taken into account, but on the accrual method for construction contracts the Commissioner does not require any inventories (Tr. 403). On the accrual method of accounting applied to a contractor it is unnecessary to take into account stock piles on hand and uncompleted work at the end of the year because the accrual method is based "on the right to receive a certain amount and the obligation to pay" (Tr. 422). It was proper accounting to accrue the retained percentages as income, and the retained percentages were actually included in the income (Tr. 422).

W. G. Williams, the revenue agent who made the report, Exhibit "20" (Tr. 593 to 619) and which appellant concedes is the basis of the deficiency assessment (Tr. p. 4), testified on direct examination that from 1938 through 1944 the account books were kept on the accrual basis; that liabilities were entered on the accrual basis and the income was entered on the billed basis (Tr. 439).

> "When the taxpayer billed the owner for the amount of construction completed and for the amount of materials and supplies in stock piles, he billed for 100% of the contract price attributed to the construction and for 75% of the contract price—75% of the cost of materials in stock piles." (Tr. 443)

He illustrated the procedure by assuming a billing of $200,000 for construction work and a billing of $100,000 for materials in stock piles, and pointed out that on such billing appellee would be paid 90% of the billing for construction work (10% being retained), and he would be paid 75% of the materials (25% being retained) (Tr. 445).

In making the examination he saw "no attempt to fraudulently evade taxes" (Tr. 461). He testified that when he used the term "inventory" he used the word "loosely" as referring to work in progress (Tr. 464). **Under the system used by appellee all inventory of work in progress was "taken into account" up to the time that they were billed on the "estimates" approved by the engineers (Tr. 465).** He conceded that the retained percentage was set up on the books and accrued to profit and loss in the taxpayer's books (Tr. 466). If there was no work in progress that was not included in the estimate, there would be no need for setting up any account for that purpose (Tr. 467). The same is true if there were no materials on hand which were not included in the estimates. There would be no need for maintaining an account for that purpose (Tr. 462). **He did not know whether there was in fact any inventory or work in progress that had not been included in the approved estimates and billings** (Tr. 468). The same system of accounting was consistently maintained from 1939 to 1944 (Tr. 471). The accounts were on the accrual basis. The income and the liabilities were

accrued on the books as of the end of the year (Tr. 471).

Mr. Williams testified that in making his computation he did not adopt the "percentage of **completion** method" but applied a "percentage of **profit** method" and that the two are not the same thing (Tr. 478). **He did not change the income that was reported in each year** (Tr. 479). **For the purpose of his computation he took the total profits for the three years, which was ascertainable only upon completion of all the work** (Tr. 482), **and divided that by the total of all costs for the three years** (Tr. 482) **to arrive at the percentage of profit to be applied to each year** (Tr. 483). **Without waiting for the full three years to expire he could not have arrived at that formula accurately** (Tr. 483). **He admitted that he applied in part a percentage of completion basis or percentage of income basis to the appellee's accrual method of accounting** (Tr. 484). **He did not apply the completed contract method.**

He was asked which of the four optional methods authorized by the Internal Revenue Code and Regulations he applied, whether it was cash, accrual, percentage of completion or completed contract basis, and he replied, "I used strictly neither one." (Tr. 486) He admitted that he ignored the methods authorized by the Act (Tr. 486, 487). He admitted (Tr. 490) that the retained percentage "was charged on the books and credited to profit and loss at the end of the year, and $200,000, the

assumed amount of billing, **was properly accrued on the books.**"

With respect to materials, he had **assumed** that the books had only accrued the portion to be paid on the "estimates" and that the retained percentage of 25% "which was not accrued has been left dangling in the air. That is my recollection as to how the matter happened," and that the 25% retained percentage had not been accrued (Tr. 491). But upon examination of the books in court, Mr. Williams testified (Tr. 513), **"I found the 25% retention to have been properly accrued on the books."** Thus he finally testified that all of the construction work had been properly accrued as to the amount presently payable as well as the retained percentage, and that as to the materials not incorporated the retained percentage as well as the amount presently due was properly accrued.

1.

Re: Sufficiency of Assignment of Error

We submit that the Assignment of Error No. I is insufficient to present any issue for consideration because it fails to supply the particularity required by **Rule 20 (d)** of this court. Appellant fails to state "wherein the findings of fact and conclusions of law are alleged to be erroneous". The question of the appropriate method of accounting involves a number of questions which were dealt with in the findings of fact. They are:

(a) whether the method employed was a true accounting method; (b) whether the taxpayer had the right to employ that method; (c) whether the accounts as kept clearly reflect the income within the meaning of the Internal Revenue Code, and (d) whether inventory and work in progress accounts had to be maintained.

No particular issue is referred to. The court is called upon to retry the case.

In **American Surety Co. vs. Fischer Warehouse Co., 88 Fed. (2d) 536, 539 (9th Cir.)**, this court held that it was not sufficient to assert generally that the court made wrong findings and thereby

> "invite this court to retry the case without indicating in what respects or for what reasons the findings are erroneous."

2.

Re: Scope of Review.

The court below made findings of fact that appellee was authorized to adopt the accrual method of accounting; that he did adopt that method of accounting; that he followed it consistently throughout all the years, including the tax years in question; that the accounts were honestly, fairly, straightforwardly and frankly maintained; that the accounts clearly reflected the income and that they were not maintained or carried on with any purpose of evading or minimizing tax liability (Tr. 27).

It is now well settled that upon review in this court these findings of fact are presumptively correct, that they will not be set aside unless clearly erroneous and that a finding is not clearly erroneous if it is supported by substantial evidence. The case is not here for trial **de novo.** The burden is upon the appellant to demonstrate that the findings are clearly erroneous.

> **Rule 52a, Federal Rules of Civil Procedure.**
> **Augustine v. Bowles, 149 Fed. (2d) 93 (9th Cir.).**
> **Lerner Stores Corp. v. Lerner, 162 Fed. (2d) 160 (9th Cir.).**
> **Hartford Accident & Indemnity Co. v. Jasper, 144 Fed. (2d) 266 (9th Cir.).**
> **Occidental Life Insurance Co. v. Thomas, 107 Fed. (2d) 876 (9th Cir.).**
> **Goldstein v. Polakof, 135 Fed. (2d) 45 (9th Cir.).**

In **Commissioner of Internal Revenue v. Scottish Amer. Inv. Co., 323 U.S. 119; 65 Sup. Ct. 169,** the court said:

> "The judicial eye must not in the first instance rove about searching for evidence to support other conflicting inferences and conclusions which the judges or the litigants may consider more reasonable or desirable. It must be cast directly and primarily upon the evidence in support of those made by the Tax Court."

3.

The Finding of Fact That Appellee Was Authorized to Adopt the Accrual Method of Accounting Is Supported by the Commissioner's Letter in Evidence.

The commissioner rejected appellee's accrual method of accounting on the assumption that appellee had not obtained permission to adopt that method. The court below found that appellee did obtain permission. Appellant asserts that the court below erred in so holding.

Prior to January 1, 1948, the contracting business was carried on by a corporation of which appellee was the owner of all of the stock. The corporation was dissolved as of December 31, 1937, and the business was thereafter continued by appellee individually until the partnership with his son was formed in 1942. At the time of the dissolution of the corporation, appellee was **individually** reporting income on the cash basis. He desired to change his individual method of accounting and reporting income from the cash to the accrual method.

To that end on March 3, 1938 he applied to the commissioner (Def. Ex. 28, Tr. 633) for permission to do so. In the first paragraph of the letter he asks that the corporation be permitted to report upon the percentage of completion basis. This had reference to the uncompleted contracts of the corporation at the time of the dissolution.

In the concluding paragraph of the letter he says:

> "In view of the fact that the corporation's books have been kept on the **accrual** basis, the individual books would be kept on a similar basis and the returns made accordingly on the **accrual** basis."

In the letter of April 5, 1938 (Tr. 636) appellee, in response to an inquiry from the commissioner, wrote:

> "The corporation has been dissolved, and all future returns will be made as an individual, and, since the main income of Ross B. Hammond is from the construction business which has been kept on an **accrual** basis, we therefore, request definite permission to make all future returns of Ross B. Hammond as an individual on the same basis as the corporation had previously made returns, which is the **accrual** basis."

In the letter of May 9, 1938 (Tr. 639) appellee furnished certain information requested by the commissioner and states (Tr. 640):

> "As previously stated, the reason for seeking permission to file on the **accrual** basis is occasioned by the fact that I have personally taken over the contracting business previously conducted by Ross B. Hammond, Inc., and, as you have been advised heretofore, the accounts of that company were kept on the accrual basis. Request has therefore been made for permission to report my income from the contracting business upon the **accrual** basis, and it is desired that the return be uniform with respect to my personal income."

On July 7, 1938 the commissioner wrote (Pl. Ex. 1, Tr. 518):

> "Predicated on the foregoing, permission is hereby granted you to change your method of reporting income **from the cash to the accrual basis,** beginning with the taxable year ending December 31, 1938.
>
> "A copy of this letter should be attached to your return for the taxable year ending December 31, 1938, as evidence of the authority given you to report your net income on the accrual basis for Federal income tax purposes."

There is some confusion (immaterial here) as to whether the corporation was on the percentage of completion or accrual basis. But there is no question at all that the **appellee individually** had been on the cash basis and that he desired to change to the accrual basis after the dissolution of the corporation. He individually was seeking the change, not the corporation. He reiterates in all his letters his desire to adopt the accrual method, and the concluding letter from the commissioner grants that request without any qualification or condition.

Appellant asserts (Br. p. 13) that:

> "Taxpayer actually received permission to use an accrual basis coupled with permission to report long-term contracts on a percentage of completion basis."

The commissioner's concluding letter, dated July 7, 1938 (Tr. 518) did not couple the two methods. The letter authorizes the adoption of the

accrual method without condition.

The Commissioner thereafter construed that letter as permission to report all of appellee's operations on the accrual method because, beginning with January 1, 1939, down to and including the tax years in question, appellee adopted the accrual method of accounting and reported his income in each of said years on that basis. The income tax returns so recite. Each of said returns was **twice examined** and **audited** and reports rendered thereon, and in no instance except in the present tax year in question did the Commissioner challenge the right of the appellee to adopt and use the accrual method of accounting and to make his returns on that basis.

It is a proper presumption that the Commissioner did not challenge the right to adopt the accrual method in recognition of the permission granted by the letter of July 7, 1938 (Ex. "1", Tr. 518).

Even if the formal permission to adopt the accrual method had not been issued by the Commissioner, the long acceptance of the returns on the accrual method would constitute an implied permission which would preclude the right of the Commissioner to reject the method in the tax years now involved.

In **Fowler Bros. & Cox v. Commissioner, 138 Fed. (2d) 774 (6th Cir.)**, the taxpayer changed his method of accounting without receiving permission

from the Commissioner, and thereafter reported his income for several years on the changed method. The court held:

> "* * * Such requirement (referring to permission) may be satisfied by the Commissioner's acceptance of returns which give notice to him that the method originally adopted has been changed; and the situation then stands as though the Commissioner had given express permission to allow the change in method of accounting."

Since it is established that the appellee did have the right to adopt the accrual method of accounting, appellant's contention that he had the right to reject that method of accounting and substitute another, insofar as it is based upon lack of authority, must be rejected.

4.

The Finding of Fact that Appellee's Method of Accounting "Clearly Reflected the Income" Is Sustained by Substantial Evidence.

It is established beyond question that if the method of accounting "clearly reflects the income" the right of the taxpayer to choose the method of accounting is "mandatory" and the Commissioner has no right to substitute another method.

> **Sec. 41, Int. Rev. Code**; Appendix p. 102.
> **Regulation 111, Sec. 29.41-1**; Appendix p. 102.
> **Huntington Sec. Corp. v. Busey, 112 Fed. (2d) 368, 370 (6th Cir.).**
> **Rowe v. Commissioner, 7 B.T.A. 903-908.**

Coatesville Boiler Works v. Commissioner, 9 B.T.A. 1242.
Index Notion Co. v. Commissioner, 3 B.T.A. 90.

Appellee could not be compelled to adopt any particular method of accounting. He has the option to choose such method "**as in his judgment best suited to his purpose**", subject only to the condition that it "clearly reflect the income". Appellee was not compelled to adopt the "percentage of completion" method of accounting.

Regulation 111, Sec. 29.42-4, p. 260; Appendix p. 105.
Orino v. Commissioner, 34 B.T.A. 726.
Security Flour Mills Co. v. Commissioner, 321 U.S. 281; 64 Sup. Ct. 596; Appendix p. 112.

Regulation 111, Sec. 29.42-4 (Appendix p. 105) defines long-term contracts and provides in subdivision (a) that gross income derived from such contracts "**may**" be reported upon the basis of percentage of completion. This provision merely makes it optional with the taxpayer. **(Orino v. Commissioner, supra.)** He cannot be compelled to adopt that method. Only when he does adopt it are the regulations pertaining to that particular method applicable.

The phrase "clearly reflect the income" is not defined by the Revenue Act or the Regulations.

Note that the phrase does not use the statutory words "gross income," or "net income". It merely

uses the word "income". Regulation 111, 29.21-1 (a), says:

> "Income (in the broad sense), meaning all wealth which flows in to the taxpayer other than as a mere return of capital."

This court and others have decided that a method of accounting "clearly reflects the income" when the books are kept "fairly," "honestly," "straightforwardly" and "frankly," as distinct from "accurately" or "without error or defect". The phrase refers to the **system** or **method** and not to any error in bookkeeping, which may be corrected by adjustment. It is established that when the books are so kept they are controlling unless there has been an attempt of some sort "to evade the tax".

In **Osterloh v. Lucas, 37 F. (2d) 277 (9th Cir.),** the court held:

> **"The method of accounting regularly employed by the petitioner is a recognized one within the meaning of the act,** and **should be accepted as controlling unless such method does not clearly reflect the income.**
>
> . . . .
>
> "The case turns largely upon **what is meant by the requirement that the method of accounting shall clearly reflect the income.** If this requirement is absolute, it is safe to say that books kept on the basis of cash received and disbursed will rarely, if ever, reflect the true income, because nearly always at the end of a tax year accounts due the taxpayer will remain uncollected and some of his own obligations will remain unpaid. But we do not think that any such literal construction was

contemplated. **In our opinion, all that is meant is that the books shall be kept fairly and honestly; and when so kept they reflect the true income of the taxpayer within the meaning of the law. In other words, the books are controlling, unless there has been an attempt** of some sort **to evade the tax.** This construction may work to the disadvantage of the taxpayer or the government at times, but **if followed** out consistently and honestly **year after year** the result in the end will approximate equality as nearly as we can hope for in the administration of a revenue law." (Emphasis supplied)

In **Welch v. De Blois, 94 Fed. (2d) 842 (1st Cir.)**, the court after quoting in full the last paragraph of the excerpt from the **Osterloh case** said:

"With this statement we fully agree."

In **Huntington Securities Corporation v. Busey, 112 F. (2d) 368-370 (6th Cir.)**, the court held, **citing the Osterloh case:**

"If the taxpayer's method of accounting clearly reflects income, the Statute is mandatory on both him and the Commissioner that taxable income must be determined in accordance therewith. The selection of a system of accounting is lodged exclusively in the taxpayer provided it is within the statutory limits of clearly reflecting income and whatever method the taxpayer adopts must be consistent from year to year unless the Commissioner authorizes a change.

. . . .

" '**Method,**' as used in the present statute, **means** the **way of keeping the taxpayer's books** according to a defined and regular plan. **'Clearly,'** as used in the statute, **means plainly,**

> **honestly, straightforwardly** and **frankly, but** does **not** means **'accurately'** which, in its ordinary use, means precisely, exactly, correctly, without error or defect.
>
> "The method used by appellant in valuing its inventories in our opinion clearly, but not accurately, reflected income, which is all that is required. Osterloh v. Lucas, 9 Cir., 37 F. 2d 277. Appellant's books of account accurately showed the cost of the securities from year to year and the differences between actual and book cost were unsubstantial. They were approximately correct on a cost basis. The errors appearing therein were easily ascertainable and correctible from the books of account which were kept plainly, honestly and straightforwardly. In our opinion, the errors of the taxpayer did not bring into operation the wide discretion of the Commissioner to reject its method of valuing inventories which was approximately correct and to select one which was at variance with the taxpayer's consistent method." (Emphasis supplied)

In **Security Flour Mills Co. v. Commissioner, 321 U.S. 281; 64 Sup. Ct. 596;** Appendix p. 112, the Supreme Court held that the phrase "clearly reflect the income" did not refer to the income in any "given year" but refers to the total income

> "over a period of years, growing out of, or in some way related to, an initial transaction in the taxable year."

Regulation 111, Sec. 29.41-2, p. 253, says:

> "Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income."

Regulation 111, Sec. 29.41-3, p. 255, says:

"The law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose."

Aside from the bare assertion that appellee's method does not clearly reflect the income and that the income is "distorted", there is not the slightest attempt made to demonstrate that the findings of fact in this respect are "clearly erroneous".

Appellee, having adopted the accrual method of accounting, treated as "gross income" all the invoices rendered based on "monthly estimates" approved by the government engineers as of the time the invoices were rendered, regardless of the time they were paid. They were accrued on the books as income in the month and year the invoices were rendered. This applied to the amounts **presently due** and the **retained percentages.** When the invoices were rendered, the "right to receive" payment accrued. The costs for labor, materials, etc. were entered upon the books as of the time in the month and year they were incurred, regardless of when paid. When the "obligation to pay" arose they were accrued on the books as "deductions".

It is now settled beyond question that the "right to receive" and the "obligation to pay" create the right and duty to accrue "gross income" and "deductions". It is mandatory that both "gross income" and "deductions" must be taken in the years in which the events occurred that give rise to the

"right to receive" and the "obligation to pay".

In **Am. Potash & Chemical Corp. v. Commissioner, 7 T.C. 1113,** the court held:

> "Where the accrual method of accounting is used items of income and expense must be allocated to the years in which the **right to receive** or the **obligation to pay** has become final and definite in amount."

> **Helvering v. Enright's Est., 312 U.S. 636; 61 Sup. Ct. 777;** Appendix p. 115.
> **Spring City Fdry. v. Commissioner, 292 U.S. 182; 54 Sup. Ct. 644;** Appendix p. 115.
> **Security Flouring Mills Co. v. Commissioner, 321 U.S. 281; 64 Sup. Ct. 596;** Appendix p. 112.
> **Frost Lumber Industries v. Commissioner, 128 Fed. (2d) 693, 694 (5th Cir.);** Appendix p. 115.
> **Pfeiffer v. Jones, 57 Fed. Supp. 621;** Appendix p. 116.
> **U. S. v. Detroit Moulding Corp., 56 Fed. Supp. 754, 757;** Appendix p. 117.
> **U. S. v. Anderson, 269 U.S. 422; 46 Sup. Ct. 131;** Appendix p. 125.
> **Willoughby Camera Stores v. Commissioner, 125 Fed. (2d) 607 (2d Cir.);** Appendix p. 120.
> **Helvering v. Russian Finance & Constr. Corp., 77 Fed. (2d) 324 (2d Cir.);** Appendix p. 123.

Appellant points to the fact that the "net income" in some instances seems to be large and in some instances small in comparison to the "gross income", but that in itself is irrelevant. Some transactions may produce large profits, others small profits, and still others losses, depending

upon an infinite variety of conditions.

For example, in one instance, appellee obtained payment of a very large sum without any expenditure, due to the fact that another corporation performed a large amount of earth filling that appellee was required to do under his contract with the government agency (Tr. 165, 166).

Then there are conditions inherent in all accounting systems resulting from the fact that at the end of a given year there is usually some "unfinished business", that is (whether on the cash or accrual basis) receipts and disbursements do not coincide in the same year.

Regulation 111, 29.43-2, p. 266, recognizes this condition and therefore provides:

> "It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts."

In this case all accruals both "gross income and deductions" were made monthly including the month of December in each year (Tr. 275). Taxpayer did not wait until the end of the year to determine whether the accruals should be taken in that year or in the succeeding year, and that was done "pursuant to a consistent policy" over the years.

Taxpayers have no choice in the matter under any accounting system under the requirements for **annual** reporting, whether it be cash or accrual method. A contractor on the cash basis may have invoiced a hundred thousand dollars of work in one year but could not treat it as income in that year if not paid. On the other hand, if he is on the accrual basis and he has invoiced a hundred thousand dollars worth of work, he **must** treat that as income although no payment has been received. The same is true of expense.

These requirements are mandatory. Whatever effect these conditions have upon the determination of statutory "net income" is inherent in the requirement for annual accounting and reporting income.

This court took note of this situation in the **Osterloh case,** supra. The court there said:

> "The case turns largely upon what is meant by the requirement that the method of accounting shall clearly reflect the income. If this requirement is absolute, it is safe to say that books kept on the basis of cash received and disbursed will rarely, if ever, reflect the true income because nearly always at the end of a tax year accounts due the taxpayer will remain uncollected and some of his own obligations will remain unpaid. But we do not think any such literal construction was contemplated."

The Supreme Court of the United States also took note of that condition in the **Security Flouring Mills Co. case,** supra.

Even if errors are found in the treatment of some entries of income or expense, it would not authorize the rejection of the taxpayer's method of accounting on the accrual basis. It would merely require **adjustment** of that item by allocation to the proper year. It would not authorize the rejection of the accounting method.

In **United States v. American Can Co., 280 U.S. 412; 50 S. Ct. 177-180,** the court held:

> " 'Basis of keeping accounts' as there used **refers to** the general bookkeeping **system followed by the taxpayer** and **not** to the **accuracy** or **propriety** of **mere individual items** or entries upon the books. And to correct an improper item in a return—whether the result of mere error or designed—cannot properly be said to constitute rejection of the basis upon which the return was constructed."

> **Bartles-Scott Oil Co. v. Commissioner, 2 B.T.A. 16;** Appendix p. 117.
> **Sneed v. Commissioner, 119 Fed. (2d) 767-771 (5th Cir.);** Appendix p. 118.
> **Merten's Law of Fed. Income Taxation, Vol. 1, Sec. 11.14, p. 493;** Appendix p. 119.

We submit that appellee's method of accounting "clearly reflected the income" as that term is interpreted in the foregoing decisions, which precluded the Commissioner from rejecting that method and substituting another.

Appellee adopted the accrual method of accounting and consistently maintained the same to and including the tax years in question. The two accountants, Brown and Eisman, who testified for

the plaintiff, as well as appellee's own bookkeeper, testified that the accounts were kept on the accrual basis; that the books set up all of the separate accounts that are usual to such method of accounting, such as accounts receivable, accounts payable, accrued taxes, accrued interest, accrued salaries, and so forth, and that the method so employed "clearly reflected the income".

Mr. Williams admitted that he found no evidence of any attempt to evade taxation by means of the method employed by appellee (Tr. 481).

The accrual method of accounting is, of course, a standard, recognized method, and under the **Regulation 111, Sec. 29.41-2,** Appendix p. 103, it "will ordinarily be regarded as clearly reflecting income".

It is clear from the record that the accounts were fairly, honestly, straightforwardly and frankly kept and maintained. There is not the slighest intimation in the revenue agent's report or in his testimony of any omission from gross income or any unwarranted addition to the deductions. The method of accounting therefore clearly reflects the income within the tests laid down in the **Osterloh case** and the others cited above.

The best evidence that the method of accounting clearly reflects the income is to be found in the fact that the Commissioner did not change a single figure relating to the **annual** "gross income" from each contract, or the **annual** "deductions" pertain-

ing to each contract, or the **total** net profit realized from each contract upon completion thereof. The Commissioner, in fact, adopted all of these figures.

The Commissioner did not reallocate any item of "gross income" or "deduction" pertaining to any contract in any of the three years that he examined.

Section 21 of the Internal Revenue Act defines "net income" as

> "the gross income computed under Section 22, less the deductions allowed by Section 23."

This is the mandatory formula for computing "net income".

Since the Commissioner did not question any of the items of "gross income" or "deduction" as reported by appellee in any of the years in question, it follows that the "net income" reported by appellee (the difference between the said "gross income" and the said "deductions") is the proper "net income to be reported".

The Commissioner accepted the items of gross income and deductions as reported, but refused to accept the net result that follows therefrom, and insists on substituting a method of determining "net profit" in violation of **Sec. 21 of the Internal Revenue Act.**

Instead of treating the difference between "gross income" and the "deductions" as the "net income", as required by **Sec. 21,** he resorted to a

formula of his own which he concedes finds no authority in the Internal Revenue Code or Regulations for determining the net income for each year. He allocated to each year only a percentage of the total net profits **ascertained upon the completion** of the contracts at the **end of three years.** The taxpayer and Commissioner are both compelled to follow the **Section 21** formula for computing "net income".

In **Clifton Mfg. Co. v. Commissioner, 137 Fed. (2d) 290 (4th Cir.),** referring to the provision which authorizes the Commissioner to adopt another method of accounting if the taxpayer's method does not clearly reflect the income, the court said:

> "But, **it can hardly be said that this authority empowers the Commissioner to add to the taxpayer's gross income for a given year an item which rightfully belongs to an earlier year under the recognized system of accrual accounting.**"

With greater reason it must be said that that provision does not authorize him to compute "net income" by a method other than that provided for in Sec. 21. The subtraction of the "deductions" computed under Sec. 23 from "gross income", as computed under Sec. 22, to arrive at the annual "net income", clearly reflects the income as a matter of law.

The method of applying a percentage of profit ascertained from a **three years' total** of net profits,

without any change in the "gross income" and "deductions", does not comply with the statute and cannot be said to clearly reflect the income. It is inconsistent with the requirements for "accrual" reporting of income.

The result of this illegal reallocation of "net income" and the recomputation of the tax based thereon was as follows:

Tax Year	Net Income per Taxpayer	Net Income per Commissioner	Tax Paid	Tax Computed by Commissioner
1941	$ 31,270.33	$ 10,821.94	$ 6,663.03	--
1942	195,680.63	370,889.23	95,991.87	$251,994.19
1943	211,306.11	127,322.61	91,307.14	49,448.91

The following tabulations show the manner in which the tax was computed by the taxpayer and as recomputed by the Commissioner:

COMBINED INCOME TAX FOR 1942-1943 AS COMPUTED BY APPELLEE AS PER CONSOLIDATED RETURN FOR 1943, PLAINTIFF'S EXHIBIT 6.

Tax for **1942** on "net income" as reported by appellee in the combined 1942-1943 return was the sum of	$95,991.87
The tax for **1943** on "net income" as reported by appellee in the combined 1942 and 1943 return was	91,307.14
Since the 1943 tax so reported was the lesser, appellee was entitled to de-	

duct 75% of the amount of that tax	68,480.36	
Leaving as the amount of tax to be paid for that year (1943)		$22,826.78
Adding the amount of the 1942 tax computed as above		95,991.87
The total of the combined 1942-1943 tax reported and paid was		$118,818.65

COMBINED TAX FOR 1942 AND 1943 COMPUTED ON "NET INCOME" AS REALLOCATED BY THE COMMISSIONER (REVENUE AGENT'S REPORT, PLAINTIFF'S EXHIBIT 20).

Tax for the year **1942** based on the reallocation (p. 9, Plaintiff's Exhibit 20)	$251,994.19	
Tax for the year **1943** based on the reallocation (p. 14, Plaintiff's Exhibit 20)	49,448.91	
Since 1943 tax was the lesser, appellee was entitled to deduct 75% of the amount so computed	37,086.68	
Leaving the amount of the tax to be paid for that year (1943		$ 12,362.23
Adding the amount of the 1942 tax computed as above		251.994.19
Total of combined 1942-1943 tax based on reallocation		$264,356.42

RECAPITULATION

Amount of tax based on reallocation of "net income"	$264,356.42
Amount of tax computed and paid on appelle's basis	118,818.65
Deficiency determined	$145,537.77
Interest to date of payment by appellee	11,609.13
Total payment	$157,146.90
Amount **paid in cash** August 17, 1945	$150,592.87
Credit allowed for refund on account of overassessment for the year 1941 plus accrued interest	6,554.03
Total	$157,146.90

(See Plaintiff's Exhibit 9, "Certificate of assessment and payment," last page.)

We invite the attention of the court to the manner in which the first contract (Job 207) appearing in the revenue agent's report (Exh. 20, Tr. 612) was treated. It is typical of the rest of the contracts and will be sufficient to illustrate the precise issue between the taxpayer and the Commissioner. The first line shows the "gross income" from that job entered on the accrual basis (as per approved estimates and invoices) for each of the years 1941, 1942 and 1943, and the last column shows the total for the three years. The Commissioner did not change any of these figures. Williams testified:

> "I have not changed the income, your Honor, that they have reported in each year.
>
> . . . .

> "I am using exactly the same income that the engineer has allowed to be billed." (Tr. 479)

The next line records the costs on that job, broken down as to labor and material, which were accrued in each of the years 1941, 1942 and 1943, as the costs were incurred. The last column shows the total for the three year period. These figures were not changed.

The next line shows the "net profits" as they were entered on the books of the appellee for each of the years, and the total at the end of the three year period. The figures of net profits were arrived at in accordance with the formula required by Sec. 21 of the Internal Revenue Code, to-wit: the subtraction of the "deductions" from the "gross income".

The Commissioner then adopts the **total** figure of net income ($37,415.05) from the job **as ascertained at the end of the three year period** (total of the 1941, 1942 and 1943 net profits); he divided that into the total "gross income" for the three year period, to-wit: $289,200.76, and determined that the net profit on the whole job upon its completion at the end of the three year period was 12.9+% of the total gross income from that job. The then computed 12.9+% of the gross income for each of the three years and treated that as the "net income" for each of the three years, instead of the net income which was arrived at by the appellee in accordance with the requirements of Sec-

tion 21 of the Internal Revenue Code. The result was a decrease of the net income in the years 1941 and 1943 and a large increase for the year 1942.

The same procedure was followed with respect to all the other contracts. We submit that the procedure followed by appellee to arrive at "net income" clearly reflects the income because it was arrived at in accordance with the requirements of Section 21, while the method employed by the Commissioner was **arbitrary, capricious** and **without any foundation** (conceded) **either in the Internal Revenue Code or Regulations,** or in **any recognized accounting system.**

The Commissioner employed a "hybrid" method. He employed in part the accrual method when he adopted the annual "gross income" and annual "deductions" as the basis for computation. (Arrived at by appellee on the accrual basis.)

He employed in part the "completed contract" method when he used the **total** gross income and deductions ascertained at the end of the three-year period.

He employed in part a "transactional" method when he used the "percentage of profit" formula.

In the **Security Flour Mills case,** supra, the Supreme Court of the United States condemned the use of a "hybrid" method of computing net income. In that case the taxpayer contended that

"Section 43 has altered the rule so that a **hybrid** system, **partly annual** and **partly transactional,** may, within administrative discretion, be substituted for that of annual accounting periods."

The court said:

"We think the position is not maintainable.

. . . .

"We are of the opinion that the purpose of the language which Congress used was not to substitute, whenever in the discretion of an administrative officer or tribunal such a course would seem proper, a **divided and inconsistent method** of accounting not particularly to be denominated either a cash or an accrual system." (Emphasis supplied)

The distortion of net income that is produced by the Commissioner's method of accounting is demonstrated by the application of his system to some of the contracts. In Job No. 213 (Tr. 615) the Commissioner computed a net income for the year 1943 of $35,448.48, and a net income in 1944 of $3,421.79; total for the two years, $38,870.27. The evidence established that the total profit realized from that contract was $27,160.05 (Tr. 501 to 504).

Similar discrepancies are disclosed by applying Commissioner's formula to contracts 215, 216, 217 and 220.

We submit that a method of accounting that produces a net profit of $38,000.00 before completion of the contract, and a total net profit of $27,-

000.00 upon completion of the contract, demonstrates such distortion as to make the adoption of the method impossible.

The obvious difficulty of adopting the Commissioner's method of accounting is that a **taxpayer could never make a return at the end of any given taxable year** if he had uncompleted contracts. If he is on the accrual basis he must make his returns annually. To apply the Commissioner's "percentage of net profit" formula, the taxpayer would have to wait in all cases until completion, because then only would he be able to determine the ratio of profit to gross income.

Appellant does not cite any authority for the right to adopt the method which he employed in this case. He concedes (Brief p. 17) that the method

> "* * * is not one explicitly provided for by the Regulations nor by the Internal Revenue Code."

The case of **William Hardy v. Commissioner of Internal Revenue, 82 Fed. (2d) 249,** is cited in support of the contention that the Commissioner "was not required to adhere strictly to a stereotyped accrual form of accounting". But this statement was made by the court in connection with the peculiar situation that existed in that case as indicated by the very next sentence which reads as follows:

> "It is obvious that there must be some leeway in making the change from the cash basis in order that the income for the first taxable period under the changed method of reporting will be reflected accurately."

In that case the controversy involved the **tax year in which the taxpayer made the change from the cash to the accrual method,** and because of the inconsistency in the two methods of accounting, it became necessary to make adjustments to compensate for the difference. In the case at bar the accounts were kept on the accrual basis and income was reported on the same basis. There was no changeover in the tax year in question from one system to another which would necessitate adjustments.

The **Hardy case** is also cited by appellant in support of the proposition that "in deciding what method is necessary clearly to reflect a taxpayer's income, the commissioner is given a breadth of discretion which, though not unlimited, will be reviewed here only when abuse of it is clearly shown".

The right accorded to the Commissioner by Section 41 of the Internal Revenue Act to substitute a method of accounting arises only when the method of accounting adopted by the taxpayer does not clearly reflect the income in the sense in which that language is employed in the Internal Revenue Act and as interpreted by the courts. If the taxpayer's method does clearly reflect the income, as that term is so used and interpreted by the courts,

the Commissioner has no right whatever to substitute any other method of accounting.

When it is established that the taxpayer's method of accounting does not clearly reflect the income, the right of the Commissioner to adopt another method attaches; but the method which he employs must be one that is recognized by the Internal Revenue Code and must accord with recognized accounting principles. He can not even then employ a "hybrid" system "partly annual and partly transactional", or "a divided and inconsistent method of accounting not properly to be denominated either a cash or an accrual system". **Security Flour Mills Co. case,** supra.

The value of the **Hardy case** as precedent is greatly impaired if not entirely dissipated by the decision of the Supreme Court in the **Security Flour Mills Co. case** in the respects just referred to.

What was said with respect to the **Hardy case** applies to the other cases cited by appellant at that point.

In **Bradstreet Co. of Maine v. Commissioner of Int. Rev., 65 Fed. (2d) 943 (1st Cir.),** the court held:

> "The burden to adopt a method that will clearly reflect the income is on the Commissioner equally as well as on the taxpayer."

In re Harrington, 1 F. (2d) 749 (D.C. Mo.), the court held:

> "This is, of course, the fundamental purpose of the law that the taxpayer should be taxed upon his actual income, and that this should neither be diminished nor increased by any arbitrary or artificial method of computation. As the law says, 'the true income must be clearly reflected,' and for this purpose the regular and long-standing methods of accounting employed by the taxpayer, established in due course and for no ulterior purpose, are to be indulged."

In **Russell v. Commissioner of Internal Revenue, 45 F. (2d) 100-101 (1st Cir.)**, the court held:

> "An arbitrary adoption of a substitute method of computing a tax, which does not in fact 'clearly reflect the income' of the taxpayers, cannot be sustained. The commissioner's discretion must be exercised reasonably, on sound grounds."

In **Carver vs. Commissioner of Internal Revenue, 10 T.C. 171**, cited by appellant, the taxpayer maintained his accounts on the accrual basis but reported income on the cash basis. This was the situation upon which the tax court held that the return did not clearly reflect the income. This was a violation of the requirement that there must be consistency between the accounts and the return. The court held that **upon the record as made** the taxpayer failed to "demonstrate error on the part of the commissioner". In the case at bar, the accounts were maintained on the accrual basis and the income was reported on the accrual basis.

There was no inconsistency. In the case at bar, unlike the situation in the **Carver case**, the court below upon the evidence found as a matter of fact that the taxpayer sustained the burden of establishing that the deficiency assessed was illegal.

It is, of course, true that the Commissioner had at the outset the benefit of the presumption of correctness. But it is now settled beyond question that the presumption is dissipated and disappears when the taxpayer has introduced evidence which negatives the presumption.

In **J. M. Perry & Co., Inc. v. Commissioner, 120 Fed. (2d) 123 (9th Cir.)**, the court held:

> "When such evidence has been adduced the issue depends wholly upon the evidence so adduced and the evidence to be adduced by the Commissioner. **The Commissioner cannot rely upon his determination as evidence of its correctness either directly or as affecting** the burden of proof." (Emphasis supplied)

> **Hemphill Schools, Inc. v. Commissioner, 137 Fed. (2d) 961-964 (9th Cir.)**; Appendix p. 111.
> **Helvering v. Talbott's Est., 116 Fed. (2d) 160 (4th Cir.)**; Appendix p. 111.
> **Lunsford v. Commissioner, 62 Fed. (2d) 740 (6th Cir.)**; Appendix p. 111.
> **Clinton Cotton Mills, Inc. v. Commissioner, 78 Fed. (2d) 292 (4th Cir.)**; Appendix p. 112.
> **Russell v. Commissioner, 45 Fed. (2d) 100 (1st Cir.)**; Appendix p. 112.
> **Whitney v. Commissioner, 73 Fed. (2d) 589 (3r Cir.)**; Appendix p. 110.

Under these decisions, when the evidence was introduced by appellee that an accrual method of accounting was consistently maintained throughout the years, that the returns were made in accordance with the accounts as kept and maintained; that as kept they clearly reflected the income, and that there was no need for inventory accounts or work in progress accounts because there were no materials or such work in progress in fact to be entered in such accounts, the presumption of correctness was dissipated and the burden of proof shifted to the government to establish that the method of accounting did not clearly reflect the income as the term is understood in the administration of the internal revenue law. The Commissioner made no attempt to meet that burden, and certainly did not introduce evidence creating a preponderance of evidence in his favor. The court below accepted that evidence and based its findings of fact thereon.

In this court, on appeal, as already pointed out, those findings of fact are presumptively correct and the burden is upon the appellant to demonstrate that those findings were clearly erroneous. We find not the slightest attempt in the Brief to make such demonstration.

Appellee and his witnesses were not impeached; their testimony was not contradicted by other testimony or by destructive analysis. The court below therefore was compelled to give credence to the evidence and to make findings of fact in ac-

cordance therewith.

> **Blackmer v. Commissioner, 70 Fed. (2d) 255 (2d Cir.).**
> **Lawton v. Commissioner, 164 Fed. (2d) 380, 384 (6th Cir.).**

In **Wright-Bernet, Inc. v. Commissioner, 172 Fed. (2d) 343 (6th Cir.) 1949,** the court reversed the decision of the Tax Court because it failed to accept and give effect to uncontradicted evidence of unimpeached witnesses.

5.

Re: Necessity of Maintaining an Inventory and Work in Progress Account

The only criticism of appellee's accrual method of accounting is based on the contention that appellee did not maintain an inventory and work-in-progress account.

This contention is predicated on the assumed applicability of **Treasury Regulation 111, Sec. 42-4 (a)** (Appendix p. 105).

We submit that this regulation does not apply to a contractor taxpayer reporting on the accrual method of accounting. It applies only to a contractor taxpayer who has elected to report on the **percentage of completion basis.** The Regulation says that contractors "may" report upon the percentage of completion basis; it does not say that he must. But it is only when the contractor elects

to adopt the percentage of completion method that he is required to supply the Commissioner with certificates of architects or engineers showing the percentage of completion, and the Regulation specifies what deductions from gross income are to be taken,

> "account being taken of the material and supplies on hand at the beginning and end of the taxable year for use in connection with the work under contract but not yet so applied."

This Regulation does not refer at all to work in progress.

No such requirement is included in the Regulations governing the reporting on the accrual method of accounting.

Regulation 111, Sec. 29.41-3, Appendix p. 104, says:

> "The law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suit to his purpose"

and in paragraph (1) it goes on to say:

> "In all cases in which the production, purchase, or sale of merchandise of any kind is an **income producing factor,** inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income."

This Regulation obviously applies only to such taxpayers as **merchants** and **manufacturers** who

buy and sell or manufacture merchandise as **an income producing factor.**

A contractor does not buy and sell merchandise as an income producing factor and is not included in that category. The contractor's income is not derived from the purchase and sale of merchandise. In the case of a lump sum contract, his income is derived from the creation of a structure, which involves the supplying of all **labor, services,** and **engineering,** in addition to the materials that enter into the structure. He does not undertake to sell the materials as such to the owner at a profit. He undertakes to supply the materials to be used **in connection with the services and labor,** all of which are merged into the construction of a project.

The Regulation obviously cannot apply to cost, plus fixed fee contracts or cost plus a percentage of cost contracts.

Appellant does not in the Brief contend that this Regulation 41-3 is applicable. We cite it only to show that the Treasury Department only deemed inventories essential in a limited type of business.

In any event, the court below made findings of fact which are supported by uncontradicted evidence that **there were no materials on hand** at any time, **or any work in progress** to be recorded in an inventory or work in progress account. Hence, there was no necessity for maintaining such accounts. The record discloses that all materials that were purchased for a given project were in-

voiced to the owner in the monthly estimates. As soon as the owner was billed for those materials, even though not incorporated, the **title to the materials passed to the owner.** They no longer were the property of the appellee and could not under any conditions be included in an inventory account.

Even in cases where inventories are required by the Regulations, it is provided specifically that the taxpayer

> "should exclude from inventory goods sold, title to which has passed to the purchaser."
>
> **(Reg. 111, Sec. 22 (c) 1, p. 60.)**

The same is true with respect to so-called work in progress. It was the uniform practice of appellee to include in the monthly estimates all the construction costs that could possibly be lawfully included under the contract, which included all the work in progress. When the estimates were approved by the engineer the amount thereof was invoiced to the owner. There was nothing left to be included in any work in progress account (assuming without admitting that such an account was necessary under the accrual system).

When such material and work in progress was invoiced it became "gross income" and was accrued as such on the books. It was in a true sense, both as to the portion presently payable, as well as the retained percentage, an "account receivable".

When the expense was incurred in the acquisition of the materials and the creation of the work

in progress, it was accrued on the books of appellee as a cost.

There was nothing left to be included in any inventory or work in progress account. They were reflected in the accounts receivable and in the accounts payable.

The testimony of appellee and his witnesses that there were no surplus materials or work in progress which had not been included in the estimates, is uncontradicted and is supported by the fact that it was the practice to include in the estimates as much as could possibly be included because appellee was in need of money and was eager to obtain the largest payments that were legally possible under the contracts.

It is also significant that the revenue agent spent twenty-three days in examining the records of the appellee, including the duplicate monthly estimates and supporting documents, which contained a wealth of detail pertaining to the quantities of materials and labor and did not in his report or in his testimony attempt to show that there was at any time on hand any material or work in progress that had not been included in monthly estimates. The revenue agent testified that he did not know whether there were any such materials or unfinished work on hand at any time.

6.

Re: Effect of Prior Determinations by the Commissioner.

The 1938, 1939, 1940 and 1941 returns were **each audited twice.** In each case determinations were made thereon, either of some deficiency or overpayment (Exh. "12" to "17" inclusive). All of the returns were on the accrual basis, based on the method of accounting uniformly employed during those years as well as the tax years in question. The method of accounting was the same throughout; no change was made in any respect whatsoever.

The Commissioner did not challenge appellee's right to adopt or maintain the accrual method of accounting or the manner in which the accounts were maintained. On the contrary, he made determinations of deficiencies and overpayments predicated thereon. We submit that those determinations have high probative value in the present controversy. No showing was made to account for the difference in the determinations.

Those determinations are entitled to the same presumption of correctness as the determinations involved in the tax years in question.

In **Hirsig v. Commissioner, Tax Court of the United States, Docket No. 6537-6538,** decision rendered August 21, 1945, Opinion by Judge Mellott, it was held:

> "The **conflicting determinations** of the Commissioner **detract from, if they do not completely nullify, any presumption of correctness** otherwise attributable to them. Cf. Helvering v. Taylor, 293 U.S. 507."

In **Bancroft v. United States, 48 F. Supp. 476-480,** the court attached significance to the fact that the Commissioner had approved an earlier return containing a declaration as to the basis of the accounting method. The court said:

> "It is worthy of observation that the plaintiffs, without any change in the method of keeping their books or filing their return for the year 1939, **had the approval of the Commissioner** when the answer on the return showed an accrual basis."

The court below had the right to reject the opinion of the revenue agent, Williams, that the accrual method followed by appellee was not properly maintained when the method (without change) had the approval of the Commissioner in all prior years.

II.

RE: ASSIGNMENT OF ERROR THAT DISTRICT COURT ERRED IN FINDING THAT AMOUNTS SET ASIDE UNDER THE MASON-PETERSEN PROFIT SHARING AGREEMENTS WERE PROPERLY ACCRUED DEDUCTIONS IN THE TAXABLE YEAR.

SUMMARY

a.

The assignment of error is insufficient to present any issue for consideration of the court in that it does not set out "separately and particularly each error intended to be urged" and it does not state "as particularly as may be wherein the findings of fact and conclusions of law are alleged to be erroneous" (Rule 20 (d) of this court).

b.

The **court is without jurisdiction** to review the order denying appellant's motion for leave to interpose the tendered set-off to the cause of action set forth in the complaint. The said order was a reviewable "decision". No appeal therefrom was taken within the time required by law and the time for such appeal had expired when the appeal from the judgment now sought to be reviewed was taken.

c.

The court below did not abuse its discretion in denying the said motion because no showing of any kind was made of mistake, inadvertence or excusable neglect or of due diligence. It was established without contradiction that appellant had full knowledge of all of the facts pertaining to the alleged set-off long before the commencement of the action.

d.

After the denial of the motion to interpose the set-off it was not a proper issue for trial in the court below, and is not now a proper issue for review.

e.

The court below did not err in holding (upon denial of said motion and in the findings) that the set-off sought to be interposed by appellant was **barred by the Statute of Limitations** and that a barred tax liability cannot be set off against a subsisting claim for refund.

f.

The court below did not err in holding on the merits of the proposed set-off that the appellee properly accrued in the tax years in question the liability to Mason and Petersen under the contracts for compensation and in taking the same as a deduction in those years.

ARGUMENT

Statement of Facts

February 3, 1942, appellee entered into an agreement with Mason, an employee, which fixed his compensation at 20% of the net profits of **"each calendar year"**. It provided for drawing $500.00 per month with maximum withdrawals for each calendar year of $10,000.00. The balance of the annual earnings "shall be permitted to remain in the company to be used as working capital for use in the contracting and construction business of the first party". Provision was made for termination of the contract by either party, and for maturing the time for payment of the accumulated earnings. The contract then provided:

> "Should the drawing account of $500.00 per month or $6,000.00 per year . . . . exceed in **any calendar years** the percentage of profits to which the second party is entitled under this agreement, this difference between the amount of money to which the second party is entitled for his services on the basis of this agreement, as outlined in Paragraph I, shall be charged against any monies which have accrued to the account of the second party and the amount of money owing the second party by the first party shall be reduced by this amount."

The contract is set forth in full in the findings of fact (Tr. 28-31).

The contract with Petersen was the same except that his compensation was 15% of the net

profits of "each calendar year", the monthly drawing account was $400.00, and the maximum drawing account for the year, $7,500.00.

The contracts did not provide that the employees were to be responsible for any losses sustained in any calendar year; and if losses had occurred in any calendar year, they could not have been charged against the compensation earned in any preceding calendar year.

It was not alleged in the proposed set-off and no evidence was introduced that these contracts were to constitute or did constitute "Contributions of an employer to an employee's trust or annuity plan for compensation under a deferred payment plan", as provided for in Sec. 23 (p)(1)(D) of the Internal Revenue Code.

In the tax years 1942 and 1943, the two years involved at this point, both employees received in cash a portion of their earnings within the limitations fixed by the contract. The rest of their earnings measured by a percentage of the profits was credited to their accounts, charged on the books of the taxpayer as an accrued liability, and was taken by appellee as a deduction in the tax years in question.

The reasonableness of the total amount of compensation credited to the accounts of these two employees has not been questioned.

The full amounts credited to their accounts were

paid to them in cash in subsequent years (Tr. 283 and Exh. 31 and 32, Tr. 648-649).

Appellee's tax return for the calendar year 1942 was filed March 15, 1943 and the return for the calendar year 1943 was filed March 15, 1944.

The **revenue agent,** who made the report upon which the deficiency in tax was assessed and paid (plaintiff's Exhibit "20"), **knew about these contracts.** Appellant concedes that the said report was the basis of the assessment of the deficiency (Br. p. 4). The agent examined the contracts (Tr. 602-605-608); he refers to and comments upon them in the report (Tr. 461-504). **He did not report that the compensation earned by the two employees in those tax years were not proper deductions to be accrued in those years and no deficiency in tax was determined and assessed by reason thereof.**

The Revenue Agent in reality recognized that the Mason and Petersen earnings were proper deductions, because he says in his report (Tr. 608):

> "It is held that all the profits of the business except for the **distribution to Mason and Petersen,** are taxable to Ross B. Hammond in his individual return."

He thus recognizes that the Mason and Petersen share of the profits was a proper deduction from appellee's profits.

The action for refund was commenced **March 16, 1946.**

July 19, 1946 (Tr. 5) appellant interposed an answer; no set-off was interposed. The Mason and Petersen transactions were not referred to. On **October 17, 1947,** (Tr. 7-8) more than three years after the filing of said returns and 17 months after the commencement of the action and 15 months after the answer was filed, appellee filed a motion for leave to interpose the tendered set-off in which it was claimed for the first time that appellee was not entitled to take any deduction for the compensation credited to the accounts of Mason and Petersen in the tax years in question; and it was claimed that by reason thereof appellee became liable for additional income tax for those years which appellant sought to offset against plaintiff's cause of action.

Neither the motion (Tr. 6) nor the affidavit of Thomas R. Winter submitted in support thereof (Tr. 7) made any showing of mistake, inadvertence or excusable neglect to account for the failure to interpose the set-off in the original answer, and made no showing of due diligence to discover the facts. **It was not alleged in the motion or affidavit that the facts were unknown to appellant.**

Appellee interposed objections to the motion as follows (Tr. 8):

(a) Failure to make any showing of mistake, inadvertence or excusable neglect;

(b) Failure to make showing of diligence to ascertain the facts;

(c) That the claim upon which the alleged set-off was predicated was barred by the Statute of Limitations;

(d) The set-off introduced for the first time an entirely new cause of action by appellant against the appellee.

The objections were supported by the affidavit of Robert T. Jacob (Tr. 9) in which he set forth the chronology of the proceedings; that the claim upon which the alleged set-off was predicated, presented a **separate** and **independent controversy, distinct from** and **unrelated** to the **transactions** upon which appellee's cause of action was predicated; that the Commissioner never made any determination of deficiency based upon the Mason and Petersen transactions and never assessed any tax by reason thereof; that all of the matters set forth in the amended answer were well known to appellant and to the Internal Revenue Bureau as early as November 6, 1944.

The facts set forth in the affidavit of Mr. Jacob were not contradicted.

After extended argument on the motion and the submission of extensive briefs, an order was made and entered on **November 14, 1947** (Tr. 18) denying appellant's motion to interpose said set-off.

The **time to appeal** from said order **expired January 14, 1948.**

Appellant did not take any appeal from the or-

der denying his motion to interpose the said set-off.

Upon the trial of the action, notwithstanding the denial of the motion to interpose the said set-off, appellant offered evidence in support thereof. Appellee seasonably objected thereto at every proper stage upon the grounds that the matter had been adjudicated by the entry of the aforesaid order. The court permitted the evidence to be introduced "subject to objection" (Tr. 117, 118, 126, 440, 207).

Upon the conclusion of the trial, the court below made findings of fact and conclusions of law pertaining to the said Mason and Petersen transactions and all of the proceedings relating to the attempt to interpose the set-off (Tr. 28-35, findings Nos. 19 to 24 inclusive, and conclusions of law No. 9, Tr. page 38). The findings state that notwithstanding that the evidence was admitted "subject to objection", the court reconsidered all of the objections in the light of the evidence and found "upon the merits" that the Mason and Petersen share of the profits was properly accrued and taken as deductions in the tax years in question.

The present appeal from the judgment in favor of the appellant was taken June 18, 1948, long after the time for taking an appeal from the aforesaid order had expired. The notice of appeal does not refer to the said order.

1.

Re: Sufficiency of Assignments of Error

Rule 20(d) of this court requires that appellant's brief should contain:

> "A specification of errors . . . . which shall set out separately and particularly each error intended to be urged . . . . the specification shall state as particularly as may be wherein the findings of fact and conclusions of law are alleged to be erroneous."

Appellee submits that appellant's assignment of error No. II (relating to the Mason and Petersen transaction) is insufficient to warrant consideration of the questions sought to be reviewed.

The Mason and Petersen transactions **involve the following of independent questions:**

> Is the set-off barred by the Statute of Limitations?
>
> Can a barred claim for tax liability be set off against a subsisting claim for refund?
>
> Did the court below abuse its discretion in denying appellant's motion?
>
> Did appellant present a sufficient showing of mistake, inadvertence or excusable neglect?
>
> Did appellant present any showing of due diligence to ascertain the facts and seasonably present the issue?
>
> Was appellant entitled to take as a deduction in the tax years in question the amounts credited to the accounts of Mason and Petersen as compensation for their services?

The assignment of error presented by appellant fails to supply the particularity contemplated by the aforesaid rule of this court. The court is invited

> "To retry the cause without indicating to us in such assignments in what respect or for what reason the findings or conclusions are claimed to be in error."

(American Surety Co. v. Fischer Warehouse Co., 88 Fed. (2d) 536, 539 (9th Cir.)

2.

Re: Reviewability of the Order Denying the Motion to Interpose the Set-off Based on the Mason and Petersen Transactions

Appellee contends that the order denying leave to interpose the set-off was a reviewable decision. This court is now without jurisdiction to review the same upon the present appeal which was taken long after the time for appeal from said order expired.

Appellant did not by that motion seek to amend his answer to correct some error affecting a defense which had already been introduced, nor did he attempt to introduce an additional affirmative defense to the cause of action set forth in the complaint.

The amended answer sought to introduce a cause of action against plaintiff as a set-off to the cause of action set forth in the complaint, based

upon **transactions which were independent of and unrelated to the transactions which gave rise to the cause of action set forth in the complaint.**

The motion for leave to file that set-off was opposed on four grounds including the **bar of the Statute of Limitations.**

The court entered an order on November 14, 1947 denying the motion for leave to interpose that set-off (Tr. 18-19) on all of the grounds of objection urged against it.

It is now well settled that an order of this character constitutes a final appealable judgment within the purview of title, **28 U.S.C.A., 225** (Now **28 U.S.C.A., 1291**); and that if appellant desired to have the same reviewed, the jurisdiction of this court should have been invoked by an appeal therefrom within the time provided by law.

Rule 54(b), Federal Rules of Civil Procedure, (prior to amendment effective March, 1948) authorizes the entry of separate judgments on particular **claims** or **counterclaims** involved in a litigation and provides that:

> "The **judgment shall terminate the action with respect to the claim so disposed of** and the action shall proceed as to the remaining claims."

In **In-A-Floor Safe Co., Limited v. Diebold Safe & Lock Co., 91 Fed. (2d) 341 (9th Cir.),** this court entertained an appeal from an order **denying a motion for leave to file a counterclaim.** Suit was brought for patent infringement. Defendant inter-

posed an answer contesting the validity of the patent but no counterclaim was interposed. Ten months later defendant moved for leave to file an amended answer and **counterclaim.** No reasons for the delay were given. The trial court granted leave to file the amended answer but **denied leave to assert the counterclaim.** This court held:

> "An order denying leave to file a counterclaim praying an injunction is an interlocutory order tantamount to one refusing an injunction, so is appealable under section 129 of the Judicial Code (28 U.S.C.A. pp. 227). General Electric Co. v. Marvel Rare Metals Co., 287 U.S. 430, 433, 53 S. Ct. 202, 77 L. Ed. 408.
>
> . . . .
>
> "It does not appear that the court abused its discretion in the instant case. The many months' delay after filing the answer is not attempted to be excused. On such a record we consider an appeal from an order admittedly discretionary as an unwarranted invasion on the time and energy of appellee and this court."

So an order denying leave to interpose a set-off because it is barred by the Statute of Limitations is "tantamount" to a judgment dismissing an action based on the claim involved in the proposed set-off and is likewise an appealable order.

In **Reeves v. Beardall, 316 U.S. 283; 62 Sup. Ct. 1085,** an action was brought to recover on a note and for specific performance of a contract. The District Court dismissed the latter count on motion of the defendant. An appeal was taken from that determination although the action was pend-

ing on the first count and the contention was made that the judgment was not final and therefore not appealable. The Supreme Court of the United States held that it was appealable.

(Text of decision so far as pertinent, Appendix, page 107.)

In **Western Contracting Corp. v. National Surety Corp., 163 F. (2d) 456 (4th Cir.)**, the court held:

> "Rule 54(b) of the Rules of Civil Procedure, 28 U.S.C.A. following section 723c, made a change in existing practice to the extent of permitting final judgment, from which appeal may be taken, to be entered at any stage of a proceeding 'upon a determination of issues material to a particular claim and all counterclaims arising out of the transaction or occurrence which is the subject matter of the claim'."

A judgment need not conclude the litigation as a whole in order to be final for purposes of appeal.

Kasishke v. Baker, 144 Fed. (2d) 384 (10th Cir.).
U. S. v. 243 Acres of Land, 129 Fed. (2d) 678 (2d Cir.).
Rubert Hermanos, Inc. v. People of Puerto Rico, 118 Fed. (2d) 752 (1st Cir.).

Upon consideration of the motion, the court had to determine, among other things, whether the set-off was barred by the Statute of Limitations. If barred, the court was required to deny the motion.

Sunlight Carbon Co. v. St. Louis & S. F. R. Co., 15 Fed. (2d) 802 (8th Cir.).

Union Pacific Railroad Co. v. Wyler, 158 U.S. 285; 15 Sup. Ct. 877.
37 C.J. 1082, Sec. 522.
37 C.J. 1074, Sec. 511.
Brown v. New York Life Ins. Co., 32 Fed. Supp. 443 (citing numerous cases).
Hartman v. Time, 64 Fed. Supp. 671, 680.

The court below made the determination, among other things, that the set-off was barred by the Statute of Limitations and entered an order denying the motion. This was a final determination that the appellant was not entitled to any relief upon the cause of action on which the set-off was based. The order denying the motion operated with the same force and effect as if the counterclaim had been interposed in the first instance and had been determined adversely to the appellant after a trial of the issues. It put an end to that litigation.

Being a "final determination" the order was appealable. Since no appeal was taken from the "determination" within the time provided by law, this court is now without jurisdiction to review that determination or the issues involved in the tendered set-off.

3.

The Court Below Did Not Abuse Its Discretion in Making the Order Denying the Said Motion

1.

An order denying a motion for leave to file an amended pleading interposing a new cause of action

or set-off is discretionary, and it is now settled beyond question that such an order is not reviewable except for abuse of discretion.

Appellant asserts (Br. pp. 27 and 28) that the court below abused its discretion in denying said motion (although there is **no such assignment of error**), but does not demonstrate such abuse. In this court the burden is on appellant to do so.

The appellant did not make any showing of mistake, surprise or excusable neglect in support of the motion to account for the failure to set up the set-off in the original pleading or due diligence to ascertain the facts so that he could seasonably interpose that set-off. The motion was made 17 months after the commencement of the action and 15 months after the filing of the original answer.

In opposition of the motion, appellee made an extensive showing of the history of the transactions involved and of the proceedings that preceeded the making of the motion (See Affidavit of Robert T. Jacob, Tr. pp. 9 to 15). The affidavit established that the Revenue Agent knew all about the Mason and Petersen transactions and the contracts from which they arose (Tr. 12-13). The allegations of this affidavit were not denied.

Upon that record it was the duty of the court below to deny the motion. Indeed it would have been an abuse of discretion to grant it upon that record.

There can be no abuse of discretion in denying a motion to file an amended pleading (especially where it seeks to interpose a new counterclaim) when the moving party **fails to make any showing** of inadvertence, excusable neglect, mistake or due diligence.

> **Frank Adams Electric Co. v. Westinghouse Electric Co., 146 Fed. (2d) 165 (8th Cir.);** Appendix p. 109.
> **Hancock Oil Co. v. Universal Oil Products Co., 120 Fed. (2d) 959, 961 (9th Cir.);** Appendix p. 110.
> **Du Pont v. United States, 28 Fed. Supp. 122-126;** Appendix p. 108.
> **Routzahn v. Brown, 95 Fed. (2d) 766 (6th Cir.);** Appendix p. 109.

We submit that under the circumstances described in Mr. Jacob's affidavit (leaving aside for the moment the application of the Statute of Limitations), the court was fully justified in denying the motion for leave to file the amended answer. There was no abuse of discretion under the facts in this case.

There certainly can be no abuse of discretion in denying leave to interpose a **barred** claim.

In **Stafford et ux. v. Roadway Transit Co., 165 Fed. (2d) 920 (3rd Cir.):**

> "Rather we conclude that the allowance of the amendment was error because it introduced into the complaint a new cause of action which was at the time barred by the statute of limitations."

In **Stephens v. Reed, 121 Fed. (2d) 696 (3rd Cir.)**, the court held:

> "There can be no abuse when what is refused would avail the offeror nothing if allowed. See Wilson v. Lamberton, et al., 3 Cir., 102 F. 2d 506, 507,"

4.

The Set-off Sought to Be Interposed Was Barred by the Statute of Limitations. It Was Not Error to Deny the Motion to Interpose That Set-off.

Section 26 U.S.C.A. 275a (Appendix p. 101), provides that income tax "shall" be assessed within **three years** after the filing of the return and contains the mandatory provision that:

> "No proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period."

No assessment was ever made for the taxes claimed by the tendered set-off based upon the Mason and Petersen transactions.

Subdivision (c) of Section 275 (Appendix p. 101) provides that if there is an omission of "gross income" in excess of 25% of the amount stated in the return, then the limitation shall be five years.

This exception does not apply to the case at bar because it does not involve the omission of "gross income" (Sec. 22). It involves the question of "deductions" (Sec. 23).

26 U.S.C.A., Secs. 3770-3775 (Appendix pp. 101-102) (formerly Secs. 607-609 Revenue Act of 1928) prohibit the application of a barred tax liability against a subsisting claim for refund and prohibit the application of a barred claim for refund against a subsisting tax liability. They also provide that any credit of a barred tax liability against a claim for refund shall "be considered an overpayment".

The returns for the taxable years 1942 and 1943 were filed March 15, 1943 and March 15, 1944.

The three year limitation fixed by Section 275 expired **March 15, 1946** and **March 15, 1947.**

No deficiency was determined or tax assessed by the Commissioner within that period **or at all** upon the claim sought to be interposed as a set-off.

The motion for leave to interpose the set-off, based on the claim arising out of the Mason and Petersen transactions, was filed **October 17, 1947** (Tr. 6, 7), which was after the last expiration date and the claim was therefore barred.

It is uniformly held that Sections 3770 to 3775 of the Internal Revenue Act preclude the crediting of a barred tax liability against a subsisting claim for refund, and preclude the crediting of a barred claim for refund against a subsisting tax liability, in cases involving tax years subsequent to the enactment of said statutes.

> **McEachern v. Rose, 302 U.S. 56; 58 Sup. Ct. 84;** Appendix p. 128.

Rothensies v. Electric Storage Battery Co., 329 U.S. 296; 67 Sup. Ct. 271; Appendix p. 130.

American Light and Traction Co. v. Harrison, 142 Fed. (2d) 639 (7th Cir.); Appendix p. 131.

Lyeth v. Hoey, 112 Fed. (2d) 4 (2d Cir.); Appendix p. 134.

Grand Central Public Market v. U. S., 22 Fed. Supp. 119-131; Appendix p. 133.

West Virginia Pulp and Paper Co. v. McElligott, 40 Fed. Supp. 765-771; Appendix p. 135.

Penn v. Robertson, 29 Fed. Supp. 386-388; Appendix p. 136.

Rotenberg v. Sheehan, 48 Fed. Supp. 584-587; Appendix p. 134.

Hall v. U. S., 43 Fed. Supp. 130-134 (Court of Claims cert. den. 62 Sup. Ct. 944); Appendix p. 135.

Mertens Law of Federal Income Taxation, Vol. 10, p. 325, Sec. 58.37.

Ronald Press Co. v. Shea, 27 Fed. Supp. 857-863; affirmed 114 Fed. (2d) 453; Appendix p. 127.

The only case cited by appellant to overcome the bar of the Statute of Limitations is **Lewis v. Reynolds, 284 U.S. 281; 52 Sup. Ct. 145.** That case has no application because it involved the tax year **1920** which preceded the enactment of what are now Sections 3770-3775 of the Internal Revenue Code.

In a number of the cases referred to above, the courts distinguished those cases from those that involved tax years preceding the 1928 amendment of the Internal Revenue Code which enacted what is now Sections 3770-3775.

In the **McEachern case,** plaintiff sued to recover a refund and defendant interposed the set-off based upon the tax liability barred by the Statute of Limitations. The Government relied in that case upon the case of **Lewis v. Reynolds.**

The Supreme Court of the United States said:

> "We may assume that, in the circumstances, equitable principles would preclude recovery **in the absence of any statutory provision requiring a different result.** But Congress has set limits to the extent to which courts might otherwise go in curtailing a recovery of overpayments of taxes because of the taxpayer's failure to pay other taxes which might have been but were not assessed against him." (Emphasis supplied)

Section 3770 (a) (2) (Appendix p. 101) declares that any payment of a tax after expiration of the period of limitation, shall be "considered an overpayment" and directs that it be credited or refunded to the taxpayer if claim therefor is filed within the period of limitation for filing such claim. Section 3775 (a) (Appendix p. 102) provides that any credit against the liability in respect of any taxable year "shall be void" if any payment in respect of such liability would be considered an overpayment under Sec. 3770 (a) (2). These provisions preclude the Government from taking any benefit from the taxpayer's overpayment by crediting it against an unpaid tax the collection of which has been barred by limitation.

In the **American Light and Traction Co. case,**

the court held that the provisions of Sec. 3770-3775 "can not be ignored", and that they preclude the application of the principle laid down in the **Lewis case.**

In the **Rothensies case,** the situation was reversed. There the taxpayer sought to set off a barred claim for refund against a subsisting tax liability. The Government took the position which is the converse of the position which it now takes. It asserted the bar of the Statute of Limitations and the Supreme Court sustained the Government saying:

> "We can not approve such encroachments on the policy of the statute out of consideration for a taxpayer who for many years failed to file or prosecute its refund claim. If there are to be exceptions to the Statute of Limitations, it is for Congress rather than for the Courts to create and limit them."

In the **Lyeth case** the Government sought to set off a barred tax liability against a subsisting claim for refund and relied upon the Lewis case. The court held:

> "Sec. 609(a) (now 3775) prevents the Government from crediting barred taxes upon the claim of a taxpayer for overpayment of any tax and Sec. 609(b) (now 3775) in like manner protects the Government against a credit of a claim for barred taxes of any kind."

In the **West Virginia Pulp and Paper Co. case,** the court pointed out that the sections which are now 3770-3775 of the Internal Revenue Code were enacted:

> "to stimulate voluntary payment of taxes by giving the taxpayer an immediate refund right **free from the danger that it will be credited against a stale deficiency."** (Emphasis supplied)

In the **Hall case** the Government contended that the taxpayer could not set off a barred claim for refund against subsisting tax liabilities. In sustaining the Government's position (which is the same as we take in the case at bar) the Court of Claims said:

> "To permit recovery by way of recoupment under the facts as disclosed by the record would be tantamount to judicial repeal of the statutory limitation provisions (referring to Secs. 3770-3775) enacted by the Congress."

The law is the same whether the claim for refund and the tax liability sought to be offset arose in different years or in the same tax year. **(Ronald Press Co. v. Shea,** Appendix p. 127.)

The prohibition against allowing the set-off of one against the other contained in Secs. 3770-3775 of the Internal Revenue Code, is made applicable to "any" tax and "any credit" and "any taxable year".

The acts are not limited to taxes or credits for a **preceding** or **subsequent** year. The comprehensive word "any" is used throughout, which, of course, relates to the same year with the same force and effect as it does to a prior or subsequent year.

To limit the application of those statutes to prior or subsequent years would be equivalent to amendment of the statute.

The case of **Niles Bement Pond Co. v. United States, 281 U.S. 357; 50 Sup. Ct. 251,** is cited by appellant in support of the proposition that "the burden rests upon the taxpayer to prove all the facts necessary to establish the irregularity of the collection". That case did not involve the question of any attempted set-off against the claim for refund. The case only involved the plaintiff's own cause of action. No attempt was made in that case to wipe out or minimize the recovery by off-setting another claimed tax liability.

In the case at bar the present controversy involves the attempted assertion of a set-off based upon an alleged tax liability which was never assessed against the taxpayer and **as to which there is no presumption of correctness.** As to that attempted set-off, the defendant had the burden of **pleading** and **proving** the facts establishing the same. This was recognized by the appellant by the very fact that he attempted to interpose an amended answer setting up the set-off.

It is now settled beyond question that it is not error to deny a motion to interpose an amended pleading to set up a claim barred by the Statute of Limitations.

In **Sunlight Carbon Co. v. St. Louis & S. F. R. Co., 15 Fed. (2d) 802 (8th Cir.),** the court held:

> "The amendment, had it been allowed, would have amounted to the bringing of an original suit against the defendant as of that date. But at that time the cause of action stated therein was barred by the Statute of Limitations of the state.
>
> . . . .
>
> "Since the proposed amendment stated a new cause of action that was barred by the Statute of Limitations, the trial court did not err in refusing to allow the amendment to be filed."

In **Stephens v. Reed, 121 Fed. (2d) 696-699 (3rd Cir.)**, the denial of a motion for leave to amend a pleading was assigned as error, the court held:

> **"There can be no abuse when what is refused would avail the offeror nothing if allowed.** See Wilson v. Lamberton, et al., 3 Cir., 102 F. 2d 506, 507."

It is well settled that a new claim interposed by an amended pleading based upon a transaction, distinct from the transaction which is the subject of the former pleading, amounts to the commencement of a new action as of the date when the amended pleading is tendered. **It does not relate back** to the date of the original pleading under Rule 15 (c) F. R. C. P.

> **Ronald Press Co. v. Shea, 27 Fed. Supp. 857-863 (affirmed 114 Fed. (2d) 453).**
> **Sunlight Carbon Co. v. St. Louis & S. F. R. Co., 15 Fed. (2d) 802 (8th Cir.).**
> **Hammond-Knowlton v. U. S., 121 Fed. (2d) 192 (2d Cir.).**
> **Hartman v. Time, 64 Fed. Supp. 671-680.**

Brown v. New York Life Ins. Co., 32 Fed. Supp. 443-444.
37 C.J., p. 1082, Sec. 522.
37 C.J., p. 1074, Sec. 511.

The claim sought to be set off by appellant in the proposed amended answer was separate and distinct from the transaction involved in appellee's cause of action, set forth in the complaint.

The original answer contained no counterclaim or set-off at all. There was no set-off to be amended.

The tax which was assessed against appellee and paid by him and which is the subject matter of the appellee's cause of action resulted from:

(a) An attack (now abandoned) upon the partnership between appellee and his son, William.

(b) The contention that appellee should have maintained his books of account and reported income on the "percentage of completion" basis instead of the "accrual basis".

The Mason and Petersen transactions were not involved in the assessment of the tax which is the subject matter of the appellee's cause of action.

The set-off sought to be interposed involves only the interpretation of the contracts between Mason and Petersen and the appellee to determine whether appellee properly took as deductions the amounts credited on the books to Mason and Petersen for services rendered in the tax years in question.

Since the tendered set-off is unrelated to the appellee's cause of action and introduced a new set-off or cause of action against appellee, the **Statute of Limitations ran against that set-off until it was tendered** and does not relate back to the time of the commencement of the action or the time of the filing of the original answer under Rule 15 (c) F. R. C. P.

5.

The Finding of Fact of the Court Below That the Appellee Properly Took as a Deduction in the Tax Years in Question the Amounts Credited to the Accounts of Mason and Petersen Is Sustained by the Uncontradicted Evidence and the Conclusion Based Thereon Is Sound as a Matter of Law.

The contracts are set forth in full in the findings of fact (Tr. 28-32). The court below made findings of fact (Tr. 32 and 33) that the share of the profits credited to their accounts were "earned" by said Mason and Petersen in the tax years in question and accrued on the books of the company in those tax years; that the contracts were made in good faith; that the profits so accrued to them "were proper deductions in the said tax years as expense, and that the said profits were subsequently paid to them in cash".

These findings of fact are **not challenged by any assignment of error** or **in the brief.** They are fully supported by the evidence. The Revenue

Agent did not in his report (plaintiff's Exhibit "20") reject these accruals, and no evidence was introduced to explain why it was improper to take the deductions.

Plaintiff's Exhibits "31" and "32" (Tr. 648-9) are the ledger accounts of Petersen and Mason and show that their share of the profits was credited to their accounts in the tax years in question and show the dates when payments were made thereon.

Appellant argues that Mason and Petersen did not "constructively receive" the income credited to their accounts and accrued as liabilities in the tax years in question.

The question of "constructive receipt" is not involved in this case. The fiction of "constructive receipt" is indulged in when accounts are maintained on the "cash basis".

It is designed to prevent tax evasion by failing or refusing to receive income when it can be received as a matter of right to postpone the tax thereon to a later tax year.

The fiction of "constructive receipt" has no place in an accrual method of accounting because the accrual method deals only with "accounts receivable" and "accounts payable" and not with "actual" or "constructive" receipts. It "ignores due dates".

It is argued that Mason and Petersen did not have an unrestricted right in the tax years involved

to demand payment of the amounts credited to their accounts. That is wholly irrelevant. We are not concerned with the question when payment was **due.** We are only concerned with the question when appellee's "obligation to pay" accrued.

Under the accrual system if a fixed liability is created in a given year, it must be accrued in that year regardless of the time when the liability is to be paid.

Appellant also points out that Mason and Petersen did not report the income in the tax years in which appellee accrued the liability on his books. That, too, is irrelevant because it appears from the record that Mason and Petersen did not report income on the accrual basis. They were on the cash basis (Exh. 26, Tr. 621-623, and Exh. 27, Tr. 627-630) and were therefore required to report their income **when received** by them and not when it was earned and accrued on the books of the taxpayer.

Mr. Williams, the revenue agent, examined the Mason and Petersen agreements and knew of the deductions. **He did not give any testimony as to why it was improper to deduct the amounts credited to the account of Mason and Petersen as expense of the operations in the years in which the deductions were made.**

The appellant contends that the liability to Mason and Petersen at the end of each year was contingent and therefore not properly accrued as expense. The argument seems to be that because

Mason and Petersen contracted to "permit" a part of their earnings to be utilized by appellant to finance the operations of the business, that the amount of profit earned could not be accrued in the years in which they were earned and credited to their accounts, but should have been credited to their accounts and taken as deductions in the year when paid.

Section 1 of the contract (Tr. 29), which permitted a portion of Mason and Petersen's compensation to remain unpaid and to be utilized by appellee in the business, did not make contingent the liability of appellee to Mason and Petersen. The liabilities became fixed and complete at the end of "each calendar year". Nothing except payment could thereafter affect that liability. **Each year was a distinct unit** for the purpose of determining the earnings for that year, and the result of subsequent years' operations could not diminish the liability created in the preceding year or years.

The time for payment could be matured by the employee by giving one year's written notice of intention to withdraw "the earnings accumulated to his account" (Tr. 30).

Section 3 provides that if the withdrawals during any calendar year exceed the percentage of profits to which the employee is entitled during such calendar year, the difference "shall be charged against any monies which have accrued to the account" of the employee and "the amount of money

owing the second party (employee) by the first party (employer) shall be reduced by this amount".

This is the provision which appellant claims renders the compensation contingent.

Appellant obviously misconstrues this provision. The provision for charging the employee's account with overdrafts in a succeeding year merely operates as **payment pro tanto** of the liability theretofore created to the extent of such overdraft in the subsequent year.

The transaction was in effect a loan or extention of credit by the employees to their employer. They were his bankers to the extent of the unpaid portion of their earnings. The liability once created became fixed and was not subject to any conditions.

That liability could, of course, be reduced or satisfied by subsequent withdrawals by the employee in excess of the amount to which he was entitled. But that merely results in payment and nothing more.

In **Lamm Lumber Co. v. Commissioner of Internal Revenue, 45 B.T.A. 1-9,** the taxpayer corporation fixed the salary of W. E. Lamm at $24,000.00 a year. Because of financial difficulties the affairs of the corporation were placed in the hands of a bank with the right to control operations including the amount of salary to be disbursed. The bank limited Lamm's withdrawals to $10,000.00 a year. The balance of the annual salary was credited to Lamm's account and carried on the books of the

company as an account payable. The corporation was on the accrual basis and took as a deduction in each year the full amount of $24,000.00. The Commissioner disallowed the deduction in excess of the $10,000.00 paid annually, claiming that the balance was not properly accruable. The court held:

> "The liability of petitioner for the salary accrued is established by the directors' action in 1926. The accrued but unpaid salary was and is carried as an account payable to Lamm, who testified that the indebtedness had not been forgiven and that he expected to collect the same. Delay in payment can not defeat the accrual where **all events had happened which fixed the liability.** The personal services were rendered by Lamm in 1936 and the liability accrued in that year. We are of the opinion that the accrual herein was proper and that the deduction of $24,000 should be allowed."

In **Tyler v. Hippach, Inc., 6 B.T.A. 636,** the court held:

> "The amount of such compensation was definitely calculable and was a fixed and legal obligation. It was an obligation **related directly and solely to the business of the particular year for which the compensation was contracted to be paid."**

Sec. 3 of the contract does not render the obligation contingent because the employees were **not to be charged with any losses that might be sustained in subsequent years.** They were chargeable only with overdrafts beyond the amount that they would be entitled to receive in subse-

quent years. If the employers sustained losses in subsequent years it would only result in the employees receiving no compensation for their services in the subsequent years. But such losses would not affect the liability of the employer to the employees for the compensation earned in preceding years. If in a subsequent year the employees did not become entitled to any compensation, any monies that they received in the subsequent years would be an overdraft which, even in the absence of a contractual provision, could be offset against the employer's liability to them. Since the operations in subsequent years could not affect the liabilities accrued in prior years, there is no basis for the contention that the liability was contingent.

Not a single case is cited in which a provision similar to the one contained in paragraph 3 of the contracts is to be deemed a contingency affecting liability within the meaning of the Internal Revenue Code. None of the cases cited on page 25 of appellant's brief lends any support to such an idea.

It is true that under the contract Mason and Petersen did not have the right to demand payment in full in the calendar year in which the amount of their share of the profits was accrued. That is not the test of accruability. The liability was complete in the tax year in question. They rendered the services for which the compensation was fixed in the tax years in question. The liability was not made to depend upon the occurrence of some contingency. Only the time of payment was postponed.

It is the very essence of the accrual method of accounting that it takes no account of the due date. **(Willoughby v. Commissioner, 125 Fed. (2d) 607.)** It concerns itself only with the accrual of the liability.

It is not true as asserted by appellant (Brief, p. 25) that the amounts credited to the accounts of Mason and Petersen were "plowed back into the business" and were "not definite obligations of the taxpayer". While the contract permitted the taxpayer to use the unpaid portion of the compensation in his business, the contract does not contemplate that the liability to Mason and Petersen was to be jeopardized by the use of the money in the business. It was not stipulated that in the event that the money was used in the business and losses resulted, the obligation should be reduced or wiped out to the extent of such loss. The taxpayer was not to speculate with such funds at the risk of the employees. He was merely permitted to use those funds in his business to the same extent as he would be authorized to use money which he borrowed from a bank for use in his business. The liability to the bank would not be affected by the fact that the bank knew or agreed that the moneys loaned were to be used in the business of the borrower. The obligation to pay would be unaffected, and therefore the permission to use the retained portion of the compensation in the business of the taxpayer did not render the obligation "contingent".

It is not true, as asserted in appellant's brief (p. 26) that the employee's additional compensation was faced with "two contingencies—his remaining in the business and the continued success of the business". The former provision, "remaining in the business," does not create a contingency. It gave the employee the absolute right to fix the date of payment. The employee had the right to fix the date of payment by giving the required notice, and the employer had the right to fix the date of payment by giving the required notice. A provision which merely creates an absolute right to fix a date of payment cannot be, and is not, a contingency affecting the liability. No authority is cited in support of that contention.

As to the second alleged contingency, "continued success of the business," we have already demonstrated that the liability is unaffected by profit or loss in succeeding calendar years, because the employee is not required to contribute any part of the losses sustained by the taxpayer in a subsequent calendar year.

There is no presumption of correctness in favor of appellant with respect to this issue. No determination of any deficiency in tax was made by the Commissioner, and no tax was assessed by reason of the Mason and Petersen transactions. The burden of proof that the deductions referred to were not properly taken in the tax years in question was upon the appellant (assuming it was properly an issue in the case). There is not a scintilla of

evidence in the record that would sustain a finding of fact that the deductions were improperly taken.

Indeed, it can with propriety be urged that there is a presumption of correctness in favor of the appellee upon this issue because the Commissioner actually made a determination of the tax liability for the tax year in question. He assessed a deficiency in tax upon the partnership issue and the method of accounting issue, but made no determination adverse to the taxpayer based upon the Mason and Petersen transactions, although the Commissioner was aware of the facts pertaining to said transactions, and they had been fully examined into as disclosed by the revenue agent's report (plaintiff's Exhibit "20"). Under these circumstances, it can properly be said that there is a presumption that the deductions taken in the tax years in question, based upon the Mason and Petersen transactions, were proper.

It is now well settled that under the accrual method of accounting the time when the liability becomes fixed determines the time when the deduction is to be taken. The time when the obligation is payable does not affect the time when the deduction is to be taken.

> **J. H. Martinus & Sons v. Commissioner, 116 Fed. (2d) 732 (9th Cir.).**
> **Cecil v. Commissioner, 100 Fed. (2d) 896 (4th Cir.).**
> **U. S. v. Utah-Idaho Sugar Co., 96 Fed. (2d) 756, 759 (10th Cir.).**

Brown v. Helvering, 291 U.S. 193; 54 Sup. Ct. 356.
U. S. v. Anderson, 269 U.S. 422; 46 Sup. Ct. 131, 134.
American Natl. Co. v. U. S., 274 U.S. 99; 47 Sup. Ct. 520.
Ohmer Register Co. v. Commissioner, 131 Fed. (2d) 682 (6th Cir.).
Willoughby Camera Stores v. Commissioner, 125 Fed. (2d) 607 (2d Cir.).
Merten's Law Fed. Inc. Taxation, Vol. 2, p. 218, Sec. 12.63.
Helvering v. Russian Finance & Construction Corp., 77 Fed. (2d) 324 (2nd Cir.).

In the **Martinus case,** supra, the court held:

> "In a case like the present, where a corporation maintains its accounts on the basis of **cash** receipts and disbursements, reasonable salaries actually paid to officers are entitled to be deducted in the year in which the payment is made. **Conversely, taxpayers** keeping their accounts and making their returns **on an accrual** basis **may deduct salaries accruing although not paid** during the tax year." (Emphasis supplied)

In the **Cecil case,** supra, the court held that the word "accrual" as used in the Internal Revenue Act

> " * * * refers to the time when the liability becomes fixed rather than when it is payable." (Citing numerous authorities.)

In the **Utah-Idaho Suga Co. case,** supra, the court held:

> "The incurring of the right to receive and of the obligation to pay definite and fixed sums accrue items for income tax purposes where books are kept and returns made on the ac-

> crual basis. Actual receipt and actual payment are not essential." (Citing several United States Supreme Court cases.)

In the **Brown case,** supra, the Supreme Court of the United States said that where accounts are kept on the accrual basis a liability incurred in the current taxable year may be treated as an expense incurred and may be taken as a deduction

> "although payment is not presently due." (Citing numerous cases.)

In the **American National Co. case,** supra, the taxpayer issued bonus contracts to persons who had purchased mortgage notes. The contracts provided for the payment of specific bonuses over a period of years. The taxpayer, who kept its books on the accrual basis, accrued the entire bonus liability that would be due over the period of years and took the total amount so accrued as a deduction in the tax year in which the contract was made. The Supreme Court of the United States held that the total amount of the bonus was deductible in the year in which the contract was made,

> "although not due and payable until the expiration of two years."

In the **Willoughby case,** supra, the taxpayer, who was on the accrual basis, took deductions for the amount of employees' bonuses which were accrued on the books as liabilities in the tax years in question but were not payable until the following year,

and the court held that the fact that no date for payment is fixed does not affect the accruability and the deductibility of an item of expense under the accrual system of accounting, and that

> "the accrual system wholly disregards due dates."

In **Helvering v. Russian Finance and Construction Corp.,** supra, the taxpayer, who was on the accrual basis, agreed to purchase six hundred thousand tons of ore, and to pay therefor a fixed price scale plus a bonus of $2.00 per ton to be paid at the expiration of ten years from the date of the agreement. The taxpayer received the six hundred thousand tons of ore in the first three years. It accrued the full liability for the bonus in the 3 years in which the ore was purchased and took a deduction therefor in those years. The court, in sustaining the right of the taxpayer to the deduction, among other things said,

> "* * * That the liability may not subsequently be discharged by payment does not necessarily prevent its consideration as a liability for the years accrued. See **Peyton-Dupont Sec. Co. v. Commissioner,** 66 Fed. 2d, 718 (2d Cir.). The possibility that a present liability may subsequently be discharged by some **condition subsequent** does not prevent its accrual on the taxpayer's books. * * * The taxpayer's liability became fixed upon delivery of the ore and there then existed reasonable grounds to justify the taxpayer in believing that it would ultimately have to pay the $1,200,000. A presently existing obligation which the taxpayer has reasonable grounds to believe must

> eventually be fulfilled, is not uncertain or contingent in the sense that it may not be accrued. See **Automobile Ins. Co. v. Commissioner,** 72 Fed. (2d) 265 (2d Cir.).
>
> . . . .
>
> "When books are kept on an accrual basis a presently existing obligation which in the normay course of events the taxpayer is justified in believing he must fulfill may be accrued."

In **Ohmer Register Co. v. Commissioner,** supra, the taxpayer entered into agreement with sales agents to pay them commissions upon sales at fixed rates. **The commissions were to be paid however as and when the customers made payments for the merchandise sold by the agents. The contracts contained provisions for the making of certain adjustments under varying conditions, which would ultimately affect the amount of the commissions in the event of the occurrence of the conditions described in the contract.** The **taxpayer** who kept its books on the accrual basis **accrued the entire commission in the tax year in which the sale was made** although the commissions were in part payable in subsequent tax years. In making its income tax return, it took as a deduction the total amount of the commission due under the contract, instead of the part of the commission that was payable during the tax year for which the return was made. The Commissioner disallowed the deductions for commissions which were due and payable in the subsequent year and based thereon assessed a deficiency in tax. The court held:

"The Board of Tax Appeals . . . . . conceded, also, that the **taxpayer may deduct,** as **expense** incurred, a **liability** which has **accrued** during the taxable year, **'although payment is not presently due.'**

. . . .

"**Corresponding,** the **right to deduct** an expense item **accrues when** the fixed **obligation** is **incurred,** even though the amount may be diminished by subsequent events. **Both sides of the ledger must be treated alike.**

. . . .

"In our judgment, the net income of the petitioner for the taxable year involved could not have been correctly determined upon the accrual basis, without deducting the commission expense from gross income. The method adopted clearly reflected the taxpayer's true income (American National Company v. United States, 274 U.S. 99, 47 S. Ct. 520, 71 L. Ed. 946), upon scientific accounting principles. (United States v. Anderson, 269 U.S. 422, 440, 46 S. Ct. 131, 70 L. Ed. 347).

"The items of **commission** expense claimed as deductible under Section 23 of the Revenue Act **were not contingent** liability but were **definitely incurred** and fixed liabilities within the taxable year."

Merten's Law Fed. Inc. Taxation, supra, says:

"Where a share of profits is definitely committed to an employee, and where those profits could be reasonably determined and **only the enjoyment** of the compensation is **postponed** or the amount to be paid is subject to later revision, an obligation is incurred which may be the basis for a deduction."

Under these decisions, the provision in the con-

tract in the case at bar deferring the payment of part of the compensation cannot be said to render the liability contingent.

In **Kaufman Department Stores v. Commissioner of Internal Revenue, 34 Fed. (2d) 257 (3rd Cir.)**, cited by appellant, the bonus agreement provided for the payment of additional compensation of two per cent of the "final net profits" earned over an **entire period of five years,** payable at the end of that period. The taxpayer accrued at the end of each year the bonus of two per cent upon the profits earned during each year. Under that agreement the liability for any bonus in any one year could not be determined until the expiration of the full period of five years because subsequent years operations could reduce or wipe out the bonus. In the case at bar, however, the liability accrued and became fixed at the end of each year. The amount thereof could not be diminished or wiped out by anything that took place thereafter.

The **Kaufman case** is typical of the rest of the decisions cited by appellant.

6.

Re: Application of Section 23 (p) (1) (D) Internal Revenue Code

It is now urged (appellant's brief, pages 26-27) that Section 23 (p) (1) (D) of the Internal Revenue Code precluded appellee from taking as a deduction the Mason and Petersen compensation in

the tax year in question.

This contention was not made in the Revenue Agent's report (Plff. Exh. 20).

This contention was not raised by the proposed set-off tendered by appellant with the motion for leave to file the same.

The proposed answer did not allege in words or effect that the contracts between Mason and Petersen and the taxpayer constituted **"contributions of an employer to an employee's trust or annuity plan and compensation under a deferred payment plan".**

Section 23 (p) is a comprehensive statute dealing, as the title indicates, with stock bonus, pension, profit sharing or annuity plans and relates primarily to the employer's "contributions" to the plan. It does not relate to ordinary contracts between employer and employee for the payment of compensation measured by commissions or share of the profits as the primary compensation. Regulation 111, page 169, specifically exempts compensation contracts from the operation of Section 23 (p).

The regulation says:

> "If an employer on the accrual basis defers paying any compensation to an employee until a later year or years under an **arrangement having the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan** deferring the receipt of compensation, he shall not be allowed a deduction until the year in which the compensation is paid. This provision

> is **not intended to cover the case where an employer on the accrual basis defers payment of compensation** after the year of accrual merely because of inability to pay such compensation in the year of accrual, as, for example, where the funds of the company are not sufficient to enable payment of the compensation without jeopardizing the solvency of the company, or where the liability accrues in the earlier year, but the amount payable cannot be exactly determined until the later year."

This interpretive regulation was obviously designed to remove any question about the application of Section 23 (p) to ordinary contracts for compensation which do not have "the effect of a stock bonus, pension, profit-sharing or annuity plan".

Appellant cites no authority for the application of Section 23 (p) of the Internal Revenue Code to the case at bar. The senate report referred to does not support appellant's contention. On the contrary it clearly negatives that conclusion. The report reads as follows:

> "If an employer on the accrual basis defers paying any compensation to the employee until a later year or years under an arrangement **having the effect of a stock bonus, pension, profit-sharing or annuity plan, or similar plan deferring the receipt of compensation,** he will not be allowed a deduction until the year in which the compensation is paid. **This provision is not intended to cover the case where an employer on the accrual basis defers payments of compensation after the year of accrual merely because of inability to pay such compensation in the accrual year."**

This statement in the report is substantially like the aforesaid quotation from Regulation 111, and the provision in the regulation was apparently inserted to carry out the precautionary observation in the Senate Report.

The provision in the contracts in the case at bar deferring the payment of part of the compensation for services was not inserted as a part of a contribution, pension, annuity et cetera plan.

CONCLUSION

The judgment appealed from should be affirmed.

Respectfully submitted,

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APPENDIX

All emphasis in quotations from statutes and decisions are supplied.

1.

Statutes and Regulations Involved.

26 U.S.C.A., Sec. 275:

"(a) GENERAL RULE.—The amount of income taxes imposed by this chapter shall be assessed within **three years** after the return was filed, and no proceeding in court **without assessment** for the collection of such taxes shall be begun after the expiration of such period.

. . . .

"(c) OMISSION FROM GROSS INCOME. —If the taxpayer omits from **gross income** an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed."

26 U.S.C.A., Section 3770, provides:

"(1) **Assessments and collections generally** —Except as otherwise provided by law in the case of income, estate, and gift taxes, the Commissioner, subject to regulations prescribed by the Secretary, is authorized to remit, refund, and pay back all taxes erroneously or illegally assessed or collected, all penalties collected without authority, and all taxes that appear to

be unjustly assessed or excessive in amount, or in any manner wrongfully collected.

"(2) **Assessments and collections after limitation period.** Any tax (or any interest, penalty, additional amount, or addition to such tax) assessed or paid after the expiration of the period of limitation properly applicable thereto shall be considered an overpayment and shall be credited or refunded to the taxpayer if claim therefor is filed within the period of limitation for filing such claim."

26 U.S.C.A., Section 3775 provides:

"**§ 3775. Credits after periods of limitation.**

(a) **Period against United States.** Any **credit against a liability in respect of any taxable year shall be void if any payment in respect of such liability would be considered an overpayment** under section 3770(a) (2).

(b) **Period against taxpayer. A credit** of an overpayment in respect of any **tax shall be void if a refund** of such overpayment would be considered erroneous under section 3774. 53 Stat. 466."

Section 41, of the Internal Revenue Code (26 U.S.C.A. 41) provides:

"The net income shall be computed upon the basis of taxpayer's annual accounting period. . . . **in accordance with the method of accounting regularly employed in keeping the books of such taxpayer;** . . . or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income."

Reg. 111, Section 29.41 - 1, page 253, provides:

"COMPUTATION OF NET INCOME. . . . The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. **If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for.** (See sections 29.42-1 to 29.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it."

Reg. 111, Section 29.41-2, page 253, provides:

"BASES OF COMPUTATION AND CHANGES IN ACCOUNTING METHODS.—**Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income.** A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are **treated with reasonable consistency.** See section 48 for definitions of 'paid or accrued' and 'paid or incurred.' **All items of gross income shall be included in the gross income for the taxable year** in which they are received by the taxpayer, and **deductions taken accordingly**, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method.

. . . .

"The true income, computed under the Internal Revenue Code and, if the taxpayer keeps books of account, in accordance with the method of accounting regularly employed in keeping such books (provided the method so used is properly applicable in determining the net income of the taxpayer for purposes of taxation), shall in all cases be entered in the return.

. . . .

"A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for the purposes of taxation, secure the consent of the Commissioner. For the **purposes of this section,** a **change** in the method of accounting employed in keeping books **means any change** in the **accounting treatment** of items of income or deductions, such as a change from cash receipts and disbursements method to the accrual method, or vice versa; a change involving the basis of valuation employed in the computation of inventories (see sections 29.22(c)-1 to 29.22(c)-8, **inclusive**); **a change from the cash or accrual method to the long-term contract method, or vice versa; a change in the long-term contract method from the percentage of completion basis to the completed contract basis,** or vice versa (see section 29.42-4). . . ."

Reg. 111, Section 29.41-3, page 255, provides:

"METHODS OF ACCOUNT.—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and **the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose.** Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as

will enable him to do so. (See section 54 and section 29.54-1.) Among the essentials are the following:

"(1) **In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, inventories** of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year (see section 22(c) and sections 29.22(c)-1 to 29.22(c)-8, inclusive."

Section 42 of the Internal Revenue Code (26 U.S.C.A. 42) provides:

"The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under Section 41 any such amounts are to be properly accounted for as of a different period."

Reg. 111, Section 29.42-1, page 257, provides:

"WHEN INCLUDED IN GROSS INCOME.—(a) In General.—Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. (See sections 29.41 to 29.41-3, inclusive.)"

Reg. 111, Section 29.42-4, page 260, provides:

"Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the

nature and terms of the particular contract. As used in this section the term 'long-term contracts' means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon either of the following bases:

"(a) Gross income derived from such contracts **may** be reported upon the basis of **percentage of completion.** In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, **account being taken of the material and supplies on hand at the beginning and end of the taxable year** for use in connection with the work under the contract but not yet so applied.

"(b) Gross income **may** be reported for the taxable year in which the contract is **finally completed** and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion."

Section 43 of the Internal Revenue Code (26 U.S.C.A. 43) provides:

"The **deductions** and **credits** . . . provided for in this chapter **shall be taken for the taxable year in which 'paid or accrued'** or 'paid or incurred', **dependent upon the method of accounting upon the basis of which the net income is computed unless** in order to clearly reflect the income the deductions or credits should be taken as of a different period."

Section 29.43-1, page 264, provides:

"'PAID OR INCURRED' AND 'PAID OR ACCRUED.'—(a) The terms 'paid or incurred' and 'paid or accrued' will be construed according to the **method of accounting upon the basis of which the net income is computed by the taxpayer.** (See section 48(c).) The **deductions and credits** provided for in chapter 1 (other than the dividends paid credit provided in section 27) **must be taken for the taxable year in which 'paid or accrued'** or 'paid or incurred,' unless in order clearly to reflect the income such deductions or credits should be taken as of a different period."

Section 48 of the Internal Revenue Code (26 U.S.C.A. 48) provides:

"The terms 'paid or incurred' and "paid or accrued' shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part."

2.

Re: Appealability of Order Denying Leave to Interpose Set-off

In **Reeves v. Beardall, 316 U.S. 283; 62 Sup Ct. 1085,** an action was brought to recover on a note

and for specific performance of a contract. The District Court dismissed the latter count on motion of the defendant. An appeal was taken from that determination although the action was pending on the first count. The contention was made that the judgment was not final and therefore not appealable. The Supreme Court held:

> "After the entry of the judgment on Count II, the claim based on the contract not to change the will was terminated and could not be affected by any action which the Court might take as respects the remaining claims. Nothing remained to be done except appeal."

3.

Re: Abuse of Discretion

In **Dupont v. United States, 28 F. Supp. 122-126** (an action to recover a tax refund), the court in denying a motion by the United States to interpose a similar defense under similar circumstances, as in the case at bar, said:

> "The whole subject was very fully discussed in Routzahn v. Brown, 6 Cir., 95 F. 2d 766. In that case a similar amendment was offered and refused after judgment in favor of the Collector and reversal by the Circuit Court of Appeals, but before a second trial. The court pointed out that the matter is discretionary, calls for the application of equitable principles, and that under the circumstances of that case **there was no inequity or abuse of discretion in denying the amendment.**
>
> "This case does not present a situation quite so strongly against the request to amend,

> but I think the equities are quite sufficient to require denial of it. **It does appear** that no specific notice was given of the purpose of the Government to raise the question of deductibility of any items other than those which have been already discussed, and **that the Treasury Department, after audit and investigation, sent the plaintiff a copy of an official report relating to the year 1932, in which there expressly appeared the deduction of the secretary's salary.** The Government filed its original answer in October, 1937, and filed an amended answer more than three months before the trial. **There is not the slightest suggestion of fraud or concealment on the part of the taxpayer.** Under all these circumstances I think it proper to deny the proposed amendment."

In **Routzahn v. Brown, 95 F. (2d) 766 (6th Cir.)**, the case referred to by the District Judge in the **Dupont case**, the court, in sustaining the action of the court below in refusing to permit amendment of the answer to introduce a similar set-off, said:

> "It is to be expected that a defendant will submit to the court in the first instance all defenses in derogation of the plaintiff's right to recover that are known to him, or which in the exercise of diligence he should have known, and indeed in equity cases the rules, Rule 30, 28 U.S.C.A. following section 723, seem to require it."

In **Frank Adam Electric Co. v. Westinghouse Elec. Mfg. Co., 146 Fed. (2d) 165 (8th Cir.)**, the court held:

> "Considering the failure of the defendant to show that its long delay in tendering its counterclaim and its second amendment was

due to oversight, inadvertence, or excusable neglect, we can not say that the court abused its discretion in refusing amendments."

In **Hancock Oil Co. v. Universal Oil Products Co., 120 F. (2d) 959-961 (9th Cir.)**, the court held:

"Whether or not this amendment would be allowed was in the sound discretion of the trial court, and the decision of that court will not be reversed except for an abuse of its discretion.

. . . .

"The proposed amendment to the counterclaim sought to set up as an **additional ground of counterclaim** an alleged violation of the Clayton Act, 15 U.S.C.A. § 15.

. . . .

"No attempt was made to show diligence on the part of Hancock to ascertain the facts alleged in the proposed amendment to the counterclaim, or to keep in touch with other suits involving the patents here involved."

. . . .

"In the circumstances we are unable to hold that the District Court abused its discretion in refusing leave to amend."

4.

Re: Burden of Proof and Presumption of Correctness

In **Whitney v. Commissioner, 73 F. (2d) 589, 591 (3d Cir.)**, the court held:

"The burden of proof was on the petitioner before the Board, and if he met it, **the burden shifted and the government was require** to come forward with evidence to refute the evi-

dence of the petitioner. It did not do so and the Board cannot draw inferences and conclusions from facts or suppositions outside of the record."

In **Helvering v. Talbott's Estate, 116 F. (2d) 160 (4th Cir.)**, the court held:

> "When such evidence is adduced, the Commissioner's finding is no longer entitled to probative force and the authority of the Board to make the controlling decision is complete."

In **Hemphill Schools v. Com'r of Internal Revenue, 137 F. (2d) 961-964 (9th Cir):**

> "Evidence having been so produced, the **presumption ceased**, and thenceforth the issue depended wholly upon the evidence.' It thus became the duty of the Board to find from the evidence, and **from it alone**, whether petitioner's gains and profits were permitted to accumulate beyond the reasonable needs of its business. No such finding was made. Instead, the Board treated the presumption **(which no longer existed)** as if it were evidence, weighed it against petitioner's evidence and concluded that petitioner's evidence did not 'overcome' it."

In **Lunsford v. Commissioner of Internal Revenue, 62 F. (2d) 741-742 (6th Cir.)**, the court held:

> "The **presumption** that the Commissioner **is** right is **procedural** and **cannot survive such proofs** unless they are challenged by contrary proofs, or destructive analysis, and we have gone so far as to say that the taxpayer's affirmative evidence may itself contain the necessary challenge and furnish the material for such analysis."

In **Clinton Cotton Mills v. Commissioner, 78 F. (2d) 292-295 (C.C.A. 4)**, the court held:

> " . . . where it appears that the method pursued by the Commissioner is erroneous, the presumption of the correctness of his determination no longer avails. Russell v. Commissioner (C.C.A. 1st) 45 F. (2d) 100, 103."

In **Russell v. Commissioner, 45 F. (2d) 100-103 (C.C.A. 1)**, the court held:

> "While there is a presumption that the Commissioner's findings are correct, Avery v. Commissioner (C.C.A.) 22 F. (2d) 6, 55 A.L.R. 1277, when it appears, as in this record it does appear, that the methods pursued by the Commissioner were mathematically and legally erroneous, that presumption no longer avails. New York Life Ins. Co. v. Ross (C.C.A.) 30 F. (2d) 80, 82."

5.

Re: Accrual Method of Accounting

In **Security Flour Mills Co. v. Com'r of Int. Rev., 321 U.S. 281; 64 S. Ct. 596 (1944)**, the Supreme Court of the United States had before it the question of the interpretation of Sections 41 to 43 of the Internal Revenue Code. The case involved the question of the **allocation** of **income** and **deductions under the accrual method** of accounting. The court held.

> "The propriety of the claimed deduction depends upon the construction of Sections 23(a), 41 and 43 of the Revenue Act of 1934."

After summarizing the provisions of Sections 41 and 43, of the Revenue Act, the court went on to say:

> "It is settled by many decisions that a taxpayer may not accrue an expense the amount of which is unsettled or the liability for which is contingent."
>
> . . . .
>
> "Petitioner nevertheless insists that Section 43 of the Revenue Act, which requires that deductions be taken for the taxable year in which the amount was paid or accrued, creates an exception applicable to this case by its concluding clause, 'unless in order to clearly reflect the income the deductions or credits should be taken as of a different period.' In short, the petitioner's position is that the Commissioner and the Board of Tax Appeals are authorized and required to make exceptions to the general rule of accounting by annual periods wherever, upon analysis of any transaction, it is found that it would be unjust and unfair not to isolate the transaction and treat it on the basis of the long term result. **We think the position is not maintainable.**"
>
> . . . .
>
> "But we think **it was not intended to upset the well understood and consistently applied doctrine that cash receipts or matured accounts due on the one hand, and cash payments or accrued definite obligations on the other, should not be taken out of the annual accounting system and, for the benefit of the Government or the taxpayer, treated on a basis which is neither a cash basis nor an accrual basis, because so to do would, in a given instance, work a supposedly more equitable result to the Government or to the taxpayer.**
>
> . . . .

"The rationale of the system is this: 'It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation.'

"This legal principle has often been stated and applied. The **uniform result has been denial both to government and to taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt of payment, or, applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and defnite in amount.**

"But the petitioner urges that Section 43 has altered the rule so that a **hybrid** system, **partly annual** and **partly transactional,** may, within administrative discretion, be substituted for that of annual accounting periods. It urges that the change was due to the desire of Congress to prevent distortion of true income. This must mean distortion of true income, not of a **given year,** but, in the light of ultimate gain, **from a series of transactions over a period of years, growing out of, or in some way related to, an initial transaction in the taxable year.** The very section on which petitioner relies, however, reiterates the adherence of Congress to the system of annual periods of computation.

. . . .

"We are of opinion that the **purpose of the language which Congress used was not to substitute,** whenever in the discretion of an administrative officer or tribunal such a course would seem proper, **a divided and inconsistent** method of accounting **not properly to be denominated either a cash or an accrual system."**

In **Helvering v. Enright's Estate, 312 U.S. 636; 61 S. Ct. 777,** the court held:

> " 'Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the **right to receive** and not the actual receipt that determines the inclusion of the amount in gross income.' "

In **Spring City F. Co. v. Commissioner of Int. Rev., 292 U.S. 182; 54 S. Ct. 644,** the court held:

> "Keeping accounts and making returns on the **accrual basis,** as distinguished from the cash basis, import that it is the right to receive and not the actual receipt that determines the inclusion of the amount in gross income. **When the right to receive an amount becomes fixed, the right accrues.**"

In **Frost Lumber Industries v. Commissioner of Int. Rev., 128 F. (2d) 693-694 (5th Cir.),** the court held:

> "In that view where the **taxpayer's books** are kept on an **accrual** basis, where the amount is reasonably certain in fact and determinable in amount, it **may be treated as a gain or a loss even though the exact amount may not have been precisely ascertained.** United States v. Anderson, 269 U.S. 422, 46 S. Ct. 131, 70 L. Ed. 347; Lucas v. American Code Company, 280 U.S. 445, 50 S. Ct. 202, 74 L. Ed. 538, 67 A.L.R. 1010. Though the computation may be undetermined, **if the basis for the computation is unchangeable** and **though the exact amount may be unknown,** if it is not unknowable, the item in such cases **is to be treated, for tax purposes, as accrued income.** Uncasville Manufacturing Company v. Commissioner, 2 Cir., 55 F. 2d 893. In Spring City Company v. Commis-

> sioner, 292 U.S. 182, 54 S. Ct. 644, 645, 78 L. Ed. 1200, the court said: 'Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the **right to receive** and **not** the **actual receipt** that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed the right accrues.' "

In **Pfeiffer v. Jones, 57 F. Supp. 621-623, Appeal Dismissed, 146 F. (2d) 1002,** plaintiff leased oil lands to an oil company in **1936**. The leasee agreed among other things to pay plaintiff a **bonus** of **$54,000.00,** approximately **one-third in cash** at the time of the agreement, **one-half** of the **balance** to be paid in **1937** and one-half of the balance to be paid in **1938.** Plaintiff kept his books and made his income tax returns on the accrual basis. He **reported** the **whole of the $54,000.00** as income in 1936 and paid the tax thereon. The Commissioner determined that the portion of the bonus to be paid in 1937 and 1938 was not income in 1936. He refunded the portion of the tax paid on the accrued income and assessed a deficiency in tax for the subsequent years, treating the payments made in 1937 and 1938 as income in those years. Plaintiff paid the assessment and sued for refund. The court made **conclusions of law** as follows:

> "Second. That the $54,000 bonus for the execution of said Oil and Gas Lease was taxable income of the plaintiff for the calendar year 1936, the year of the execution of said lease, the taxpayer being on an accrual basis and such bonus being unconditionally guaran-

teed by an enforecable contract in writing executed by a solvent obligor, whose credit was unquestioned. That the Commissioner erred in determining that part of said bonus was income for the calendar year 1937, and the Commissioner was further in error in determining that part of said bonus was income for the calendar year 1938. That the Commissioner was in error in making said deficiency assessments."

In **United States v. Detroit Moulding Corporation, 56 F. Supp. 754-757,** the court held:

> "Where, as here, in accrual accounting **by calendar year** periods for income tax purposes, **all the events occur within a calendar year which fix the amount and the fact** of a taxpayer's liability for an excise tax accrued **though not paid,** which liability is neither contested by the taxpayer nor contingent and not changed within a reasonable time after the close of the calendar year, **proper accounting practice requires** that **such liability** be **accounted** and **deducted** as **accrued** during such year, and, if such liability is lessened by unexpected events occurring in a subsequent year, after the income tax return has been filed, **proper accounting** practice **requires** that this **be reflected by an entry in the subsequent year,** crediting **as income** the amount by which the obligation has been so lessened, **rather than by re-opening and adjusting the taxpayer's books** for the **previous year.**" (Citing numerous cases)

In **Bartles-Scott Oil Co. v. Commissioner, 2 B.T.A. 16,** the board held:

> "The mere fact that some deferred charges and credits to income may not have been included in the accounts carried cannot destroy

the principle upon which the system of accrual bookkeeping is based."

In **Sneed v. Commissioner of Internal Revenue, 119 F. (2d) 767-771 (5th Cir.):**

"**Congress** could fix decennial periods instead of annual ones. **It** has in general **adopted** the **annual plan,** but has **authorized either actual receipts and disbursements or accrual** as the basis for accounting. On the latter basis, there may be a difference of years in entering the items on the account from what would have been true on a basis of actual receipts and disbursements. But these **two bases are elastic,** for in the Revenue Act of 1926, Sec. 200(d), 26 U.S.C.A. Int. Rev. Acts, page 146, which directs income and deductions to be accounted for in the year received and paid or accrued, there is an exception: 'Unless in order to clearly reflect the income the deductions or credits should be taken as of a different perioa.' Similar language occurs in the other Acts. The clear reflection of income that ought to be taxed is the main object. See Guaranty Trust Co. v. Commissioner, 303 U.S. 493, at page 498, 58 S. Ct. 673, 82 L. Ed. 975. With or without the aid of a Regulation, there have been many cases of this so-called 'restoration to income' of a deduction taken in a prior year. **On the accrual basis, if a tax, or expense, or other deduction is taken one year as accrued, but it turns out in another year that there was no such liability or a less one, the matter is corrected by a charge to income as though there had been a recovery back.** Charleston & W. C. Ry. Co. v. Burnet, 60 App. D.C. 192, 50 F. (2d 342; Chicago, R. I. & P. Ry. Co. v. Commissioner, 7 Cir. 47 F. 2d 990; Nash v. Commissioner, 7 Cir., 88 F. 2d 477. So when on a cash basis a debt is deducted as bad and in another year is col-

lected in whole or in part, the matter is corrected not by going back to the year of deduction, but by a charge to income in the later year. Askin & Marine Co. v. Commissioner, 2 Cir., 66 F. 2d 776; Putnam Bank v. Commissioner, 5 Cir., 50 F. 2d 158."

In **Vol. 1 Mertens Law of Federal Income Taxation, Sec. 11.14, p. 493,** the author says:

"§ 11.14.—The Taxpayer Must Select One Method of Accounting. As has been seen, the statute recognizes at least two methods of accounting. It is clear that the same **taxpayer cannot at one time have two bases of accounting; he may not use inconsistent bases at the same time. He may not combine the cash and accrual bases. He must use one method or the other.** Amounts of income within the year under the method employed must be returned that year even though part may have been improperly reported in some other year. It will not be presumed that an item was omitted in a previous year. The method of accounting used by the taxpayer must be **'consistent within its own sphere.'** Two distinct businesses of an entirely different character owned by the same individuals but operated independently and keeping separate accounts need not report on the same accounting basis. What accounting method is used is determined by the facts, not by what the method used is called. **But this does not mean that a method must be 100% cash or accrual; minor deviations from the cash basis are not sufficient to cause books to be placed upon the accrual basis. The converse is also true. A hybrid method is not acceptable,** but a method may be substantially or fundamentally the accrual method and not a hybrid method. **To be kept on the accrual basis the books need not have every element of the high-**

est scientific accrual method. The general and controlling character of the accounts determines which method is employed, not the label which the taxpayer chooses. It has been held that evidence as to accounting method in years other than the taxable year is admissible in determining a question as to the taxable year since 'the entire story is pertinent and useful.' It is **not possible** to **adhere** to **absolutely definite rules** in all types of businesses and **minor departure** will **not necessarily cause the scale to turn** for or against the method insisted upon. **There must not be a too strict regard for insignificant errors or too slavish adherence to prescribed theories or methods.** The controlling intendment of the statute must be kept in mind that a method of accounting should be followed if it substantially reflects true income."

In **Willoughby Camera Stores v. Com'r of Internal Revenue, 125 F. (2d) 607-608 (C.C.A. 2d, 1942)**, the court held:

"The issue here is whether petitioner was entitled to deduct from gross income, as business expenses under § 23 (a) of the Revenue Acts of 1934 and 1936, 26 U.S.C.A. Int. Rev. Code, § 23 (a), certain amounts which it set up on its books as reserves for **employees' bonuses.** The amounts were **deducted** in **1935** and **1936,** although **not paid until the following years,** and the disputed **question** is whether the taxpayer, which is on the **accrual system,** was entitled to make the deductions in **the earlier years.** The Board of Tax Appeals held that there was, when the accounts were set up, no legal liability to pay the amounts credited to the bonus reserve. **We disagree.**

"Mr. Riggles, president of the corporation, testified that, at the time of hiring, the em-

ployees (who are called 'co-workers') 'are told that we run a cooperative organization, that they are co-partners of the business, and after two years' service they participate in a general bonus distribution.' While 'co-partners' may be too glorified a title for an employee whose claim to it is membership in a profit-sharing scheme, petitioner has succeeded in establishing that it was **obligated to pay bonuses in some amount.** Where such an inducement is held out to an employee at the time of hiring, it is familiar doctrine that there is an **implied contract to make payments.** See Annotation, 28 A.L.R. 331. This is in accord with the reasonable expectation of the employee, an expectation which is heightened where, as here, similar hopes have been stimulated in his fellow-employees and where the employer's custom has been to satisfy those hopes. In such circumstances, it has been held, the employee may sue for his bonus, though his recovery may be limited to a nominal amount. He is protected, furthermore, against a forfeiture of his rights by an arbitrary discharge. Annotation, 28 A.L.R. 346.

"No doubt the obligation imposed on the employer by such a contract, while the amount remains both unknown and unknowable, will not serve as the basis of a deductible accrual. On the other hand, **there can be no doubt about the deductibility of an accrual, if the amount thereof may be determined by a fixed formula,** as by a percentage of profits. Petitioner argues, and we agree, that an adequate substitute for such a formula is to be found in the fact that in December of each year the board of directors meets to determine how much shall be paid as bonuses during the next year. Following this determination, a memorandum is handed to the treasurer, who credits this amount to 'Reserve for Bonus or Extra Com-

pensation' and charges it to profit and loss. The **action of the board of directors,** while not as inflexible as a formula, **must be regarded,** in view of the company's custom, **as definitely fixing a minimum for the amount to be paid.** The amount was known to the employees, . . . As in the case of Continental Tie & Lumber Co. v. United States, 286 U.S. 290, 52 S. Ct. 529, 76 L. Ed. 1111, **all the events necessary to a determination of the amount to become due were present in the taxable years.** (Cases)

"The Board of Tax Appeals held that an employee of the taxpayer could not ascertain, within the taxable year, his proportionate share of the accrual. We do not regard that as relevant to the issue of deductibility. If the directors' decision had been subject to revocation, the existence of a formula by which an employee could compute his share of a tentative amount would add nothing to the propriety of an accrual; similarly, if the sum was set aside finally and without reservation as a liability to the group, the absence of a formula for individual distribution would in no way impair the accuracy, from an accounting point of view, of the accrual as a reflection of the company's affairs. **In view of the custom followed by this company,** we think that its promise to its 'co-workers' was twofold: (1) to pay at least some amount as a bonus, and (2) to pay at least the amount, if any, set up on its books at the end of each year as a reserve for bonuses. Thus the **enforceable obligation** to pay a nominal sum, found in the usual case, was in this one supplanted at the time of the directors' meeting by a promise **to pay in the aggregate, at least the amount set up in the reserve.** That obligation could have been enforced by the employees as a class, and we do not think that a court would be unable to devise some equitable method for apportioning

> the sum among them. **The fact that no date for payment was set at the December meeting is irrelevant; under the accrual system of accounting the use of the word 'accrued' does not signify that the item is due.** On the contrary, the **accrual system** wholly **disregards due dates.** United States v. Anderson, 269 U.S. 422, 425, 46 S. Ct. 131, 70 L. Ed. 347. If the issue here were when payment becomes due, we would be required to select some date reasonable under the circumstances, presumably the end of the succeeding year; but we are not faced with that task.
>
> **"Since there was an obligation enforceable within the taxable year, the deductions were proper.** The order of the Board of Tax Appeals, therefore, is reversed."

In **Helvering vs. Russian Finance & Construction Corp., 77 Fed. (2d) 324 (2d Cir.),** the taxpayer agreed to purchase from an organization six hundred thousand tons of ore and to pay therefor at a fixed price scale plus a bonus of $2.00 per ton to be paid at the expiration of ten years from the date of the agreement with interest payable semi-annually from the date of deliveries. The taxpayer was on the accrual basis and according accrued all purchases of the ore thus obtained in the years when the purchases were made and accrued the full sum of $1,200,000.00, being the $2.00 per ton for the six hundred thousand tons in the three years that it obtained delivery of said ore, and took the amount so accrued as a deduction in the years in which they were accrued as liabilities. The Commissioner of Internal Revenue disallowed this de-

duction contending that the amount was not properly accrued in those years, the court held:

> "In order to be accruable in the taxable year for which the return is made, a valid obligation to pay must have existed in that year, which is enforceable on the date when the obligation is due.
>
> . . . .
>
> "When the right to receive income or the obligation to expend money is certain, not dependent upon the happening of some contingency, it may be classified as accrued.
>
> . . . .
>
> "The taxpayer's liability became fixed upon delivery of the ore, and there then existed reasonable grounds to justify the taxpayer in believing that it would ultimately have to pay the $1,200,000. A presently existing obligation, which the taxpayer has reasonable grounds to believe must eventually be fulfilled, is **not uncertain or contingent** in the sense that it may not be accrued. See Automobile Ins. Co. v. Comm'r, 72 F. (2d) 265 (C.C.A. 2).
>
> "The basis of the accrual system of accounting is that obligations incurred in the normal course of business will be discharged in due course. United States v. American Can Co., 280 U.S. 412, 50 S. Ct. 177, 74 L. Ed. 518. This is a necessary assumption. Conditions in the contract which would here have discharged the taxpayer from the liability it incurred upon delivery of the ore were not of a nature which would justify it in believing it would not have to pay the $1,200,000. The conditions never occurred, as the record disclosed, and **the liability was in fact discharged by payment.** When books are kept on an accrual basis, a presently existing obligation, which, in the normay course of events, the taxpayer is justified

in believing he must fulfill, may be accrued.

. . . .

"The fundamental requirement is that the return reflects true income, and expenses must be set off against the income to which they are attributable. United States v. Anderson, supra; Miller & Vidor Lumber Co. v. Comm'r, 39 F. (2d) 890, 892 (C.C.A. 5). In the latter case, the court said: 'We think these cases and the regulations clearly establish the rule that, as to taxpayers making their returns on the accrual basis, deductions attributable to the business of a particular year must be applied against the income they help to create from the business of that year, and not against that of a subsequent year in which payment was made.'

"In the instant case, the contract provided that payment of the $2 per ton was additional payment for the ore. Consequently, the $1,200,000 constituted part of the cost of the ore, and the taxpayer so entered this cost upon its books. When the ore was sold by the taxpayer during the taxable years in question, the true income derived from such sale could be ascertained only by offsetting the complete cost of the ore, including the $1,200,000, against the price received upon its sale. Postponing the deduction to the year when the $1,200,000 was actually paid would not reflect true income for that year, but would distort the income."

In **United States v. Anderson, 269 U.S. 422; 46 Sup. Ct. 131,** the taxpayer in the year 1916 sold munitions upon which it was required to pay munitions' taxes. These taxes were due and payable in 1917 and were paid in that year. Taxpayer took as a deduction in 1917 the amount so paid. The commissioner disallowed the deduction on the ground

that the taxpayer was on the accrual basis and should have taken the deduction in 1916. The Supreme Court held:

> "Only a word need be said with reference to the contentions that the tax upon munitions manufactured and sold in 1916 did not accrue until 1917. In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, **all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it.** In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions ta xhere in question did not stand on any different footing than other accrued expenses appearing on appellee's books. **In the economic and bookkeeping sense with which the statute and Treasury decision were concerned, the taxes had accrued.**
>
> . . . .
>
> "We conclude that the reserves for taxes which appeared on appellee's books in 1916 were deductible under section 13(d) (now sec. 23) of the Act of 1916 and Treasury Decision 2433 in its income tax return on the accrual basis for that year.
>
> "It was argued in behalf of the appellees in No. 337 that the taxpayer did not keep its books on an accrual basis;
>
> . . . .
>
> **"On this point we are concluded by the findings."**

Re: Statute of Limitations

In **Ronald Press Co. v. Shea, 27 Fed. Supp. 857-863,** affirmed **114 Fed. (2d) 453 (2d Cir.),** the original complaint sought refund of taxes paid upon determination of a deficiency resulting from the liquidation of subsidiary companies. By the amended complaint plaintiff sought recovery for **additional loss** sustained **in the same tax year,** resulting from the charging off of bad debts transactions distinct from those involved in the original complaint. The court held:

> "The first special defense is that the amended complaint set forth new and distinct causes of action, which were not contained in the original complaint and were **not brought within the time limited by law for commencing an action thereon,** and are therefore barred. I think the defense is good. It is true that 'a liberal rule should be applied.' New York Central & H. R. R. Co. v. Kinney, 260 U.S. 340, 346, 43 S. Ct. 122, 123, 67 L. Ed. 294 and that **Rule 15(c)** of the new Federal Rules of Civil Procedure which went into effect September 16, 1938, 28 US.C.A. following section 723c, permits the amended pleading to date back to the original pleading, where the claims asserted in the amended pleading arose out of the transaction set forth or attempted to be set forth in the original pleading. But the amended complaint does not meet the condition. Not only are the amounts and dates different but there are pleaded certain basic allegations, such as the making of the agreement of January 3, 1928, which are not mentioned in the original complaint. Likewise, there are important allegations of the original complaint which do not

> appear in the amended complaint. (Compare paragraphs 9, 22 and 24 of the original complaint with paragraphs 13 and 14 of the amended complaint.) Having in mind the provisions of the stipulation and the special defense, I conclude that the causes of action pleaded in the amended complaint are barred by the Statute of Limitations controlling suits against the United States to recover taxes illegally collected. 26 U.S.C.A. §§ 1672-1673 and notes thereunder."

In **McEachern v. Rose, 302 U.S. 56; 58 S. Ct. 84,** plaintiff sued to recover a refund. Defendant interposed a barred set-off against the tax liability. The Government relied upon the principle set forth in **Lewis v. Reynolds, 284 U.S. 281; 52 S. Ct. 145** (the case which defendant relies on in the base at bar). (See decision of Circuit Court of Appeals, 86 F. (2d) 231.) The Supreme Court of the United States held:

> "We may assume that, in the circumstances, equitable principles would preclude recovery **in the absence of any statutory provision** requiring a different result. But **Congress has set limits to the extent to which courts might otherwise go in curtailing a recovery of overpayments of taxes because of the taxpayer's failure to pay other taxes which might have been but were not assessed against him.** Section 607 of the 1928 Act (26 U.S.C.A. Sec. 3770 (a) (2)) declares that any payments of a tax **after expiration of the period of limitation,** shall be considered an overpayment, and directs that it be 'credited or refunded to the taxpayer if claim therefor is filed within the period of limitation for filing such claim;' and section 609 (a) of the 1928 act (26 U.S.C.A., Sec. 3775

(a)) provides that 'any **credit** against a liability in respect of any taxable year **shall be void if** any **payment** in respect of such liability **would be considered an overpayment** under section 607 (3770(a)(2)).' **These provisions preclude the government from taking any benefit from the taxpayer's overpayment by crediting it against an unpaid tax whose collection has been barred by limitation.**

"It is plain that **these provisions forbid credit** of the overpayments of taxes for 1930 and 1931, which were made after collection of the 1928 tax was barred. If petitioner had then paid the 1928 tax, there would have been an overpayment of the tax, refund of which is made mandatory by section 607. **Credits** against the tax of overpayments of taxes assessed for other years, if made at that time, could not stand on any different footing under the provisions of section 609 (26 (U.S.C.A., Sec. 3775). The right of the government to credit the overpayments upon the earlier unpaid tax could arise only when the overpayments occurred; but **since** at that time **collection** of the 1928 tax **was barred** by limitation, and payment of it would be an overpayment, **credit against it of the 1930 and 1931 overpayments was forbidden** by section 609 (3775).

. . . .

"If petitioner had then paid the (barred) tax he could have recovered it back as an overpayment under section 607 (3770); accordingly, credit against the tax of the 1929 overpayment is prohibited by section 609 (3775), as are like credits for the overpayments of 1930 and 1931.

"The similar treatment accorded by the statutes to credit against an overdue tax, and to payment of it; the prohibition of credit of an overpayment of one year against a barred deficiency for another; and the requirement

> that payment of a barred deficiency shall be refunded, are **controlling evidences of the congressional purpose** by the enactment of sections 607 (now 3770) and 609 (3775) **to require refund** to the taxpayer of an overpayment, **even though he has failed to pay taxes for other periods, whenever their collection is barred by limitation."**

In **Rothensies v. Electric Storage Battery Co., 329 U.S. 296; 67 S. Ct. 271,** the taxpayer insisted on the right to set off the amount of his claim for refund which was barred by the statute of limitations against his subsisting tax liability. **The Government made the same contention as the plaintiff makes in the case at bar,** namely, that a barred liability cannot be set off against a subsisting liability and the Government was sustained in that contention. The court held:

> "It probably would be all but intolerable, at least Congress has regarded it as illadvised, to have an income tax system under which there never would come a day of final settlement and which required both the taxpayer and the Government to stand ready forever and a day to produce vouchers, prove events, establish values and recall details of all that goes into an income tax contest. **Hence a statute of limitation is an almost indispensable element of fairness as well as of practical administration of an income tax policy.**
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> "As statutes of limitation are applied in the field of taxation, the taxpayer sometimes gets advantages and at other times the Government gets them. Both hardships to the taxpayer and losses to the revenues may be pointed out.

They tempt the equity-minded judge to seek for ways of relief in individual cases.

"**But if we should approve a doctrine of recoupment of the breadth here applied we would seriously undermine the statute of limitations in tax matters.** In many, if not most, cases of asserted deficiency the items which occasion it relate to past years closed by statute, at least as closely as does the item involved here. Cf. Hall v. United States, 95 Ct. Cl. 539, 43 F. Supp. 130. **The same is true of items which form the basis of refund claims. Every assessment of deficiency and each claim for refund would invite a search of the taxpayer's entire tax history for items to recoup.**

. . . .

"We cannot approve such encroachments on the policy of the statute out of consideration for a taxpayer who for many years failed to file or prosecute its refund claim. **If there are to be exceptions to the statute of limitations, it is for Congress rather than for the Courts to create and limit them.**"

In **American Light & Traction Co. v. Harrison, 142 F. (2d) 639 (7th Cir.)**, the court held:

"Plaintiff brought this action to recover $251,053.55 in income taxes admittedly overpaid for 1933. Although he admitted every allegation of fact contained in plaintiff's complaint, defendant endeavored to defeat recovery by affirmatively pleading that plaintiff had underpaid its taxes for 1928 by $342,180.50, **the collection of which was barred by the statute of limitations.**

. . . .

"The Government's **failure to collect the tax** for 1928 was **not caused by any misrepresentation or misleading silence on plaintiff's**

part, but resulted from an opinion of the General Counsel for the Bureau which, in 1940, turned out to be erroneous under LeTulle v. Scofield, 308 U.S. 415, 60 S. Ct. 313, 84 L. Ed. 355.

. . . .

"Since an action to recover a federal tax erroneously paid is in the nature of a common law action for money had and received and is governed by equitable principles, United States v. Jefferson Electric Mfg. Co., 291 U.S. 386, 402, 403, 54 S. Ct. 443, 78 L. Ed. 859, and since equitable principles would preclude a recovery in the instant situation, plaintiff could not recover **if there were no statutory provisions involved. Here, however, there are such provisions which cannot be ignored.**

"Section 607 of the Revenue Act of 1928, 45 Stat. 791, 874, **26 U.S.C.A.** Int. Rev. Code, § **3770(a) (2)**, which is **significantly entitled 'Effect of Expiration of Period of Limitation** Against United States,' provides that any payment of a tax after the expiration of the applicable period of limitation shall be considered an overpayment and directs that it be '* * * credited or refunded to the taxpayer if claim therefor is filed within the period of limitation for filing such claim.' Under this section, any payment of the barred deficiency for 1928 would constitute an overpayment, the refund of which would be mandatory. Section 609(a) provides that 'Any credit against a liability in respect of any taxable year shall be void if any payment in respect of such liability would be considered an overpayment under section 607.' 45 Stat. 875, **26 U.S.C.A. In Rev. Code,** § **3775 (a).** Since the payment of a barred deficiency for 1928 would constitute an overpayment under § 607 (now 3770), it necessarily follows that any credit of the 1933 overpayment

against that barred deficiency would be void under § 609(a) (now 3775). In the light of these provisions, the only possible conclusion is to affirm the District Court's judgment for the plaintiff. Any other result would effect a judicial repeal of the Act of Congress.

. . . .

"Probably moved by the desire **to stimulate voluntary payment** of taxes by giving the taxpayer an immediate refund right **free from** the **danger** that **it would be credited against any stale deficiency, Congress enacted the instant statutory provisions.** At any rate, Congress did enact these provisions which we are not free to suspend or apply at will, nor to shape to our notion of the ends of justice. Although here a hardship on the Government results from the taxpayer's inconsistency, the correlative provisions of this same statute will, in the converse of the instant situation, work an equal hardship on the taxpayer. Hall v. United States, Ct. C., 43 F. Supp. 130. In the instant case, our power to construe the statute is narrower than usual and closely circumscribed, because the Supreme Court has given an authoritative interpretation in the McEachern case.

"The judgment is affirmed."

In **Grand Central Public Market v. United States, 22 F. Supp. 119-131 (Calif.)**, the court held:

"In this recent McEachern Case it was held that the equitable defense of setoff, unjust enrichment, or recoupment is not available to the government if the application of such a defense would result in crediting a later overpayment upon a barred tax liability

"It is indeed unfortunate that in this instance the plaintiff will be able to avail itself

of the technical defense of the statute of limitations, in order to avoid the collection by the government of a very considerable sum in income taxes for the years 1925 to 1928, inclusive. These taxes, plaintif at one time properly and legally owed, but **no fraud or concealment has been alleged or proved by the government** and we feel that the bonus receipts were known or should have been known at all times to the Commissioner's agents. To ignore the statute would in our judgment, produce results much more serious than any possible loss of revenue. Congress certainly had a special object in view in enacting the statute of limitations and, to accept the theory of the defendant in this case, would be to defeat the clear intent of Congress to fix a definite period of time as a limit upon collectibility of income tax.

. . . .

"Under the circumstances we are unwilling to reduce or wipe out plaintiff's recovery by offsetting the taxpayer's liability for any year prior to 1929."

In **Lyeth v. Hoey, 112 F. (2d) 4 (2d Cir.)**, plaintiff sued for refund of taxes. Defendant interposed a set-off based on a claim for unpaid taxes which was barred by the Statute of Limitations at the time the answer was filed. The court held:

"Section 609(a) (now 3775) prevents the government from crediting barred taxes upon the claim of a taxpayer for overpayment of any tax and section 609(b) in like manner protects the government against a credit of a claim for barred taxes of any kind."

In **Rotenberg v. Sheehan, 48 F. Supp. 584-587,** the court held:

> "The amount of unpaid taxes on independent transactions may not, after their collection is barred by the Statute of Limitations, be set off against claims for refund. McEachern v. Rose, 302 U.S. 56, 58 S. Ct. 84, 82 L. Ed. 46."

In **Hall v. United States, 43 F. Supp. 130-134, Court of Claims, Certiorari Denied, 62 S. Ct. 944,** the situation was reversed. The taxpayer claimed the right to recoup against a tax liability a claim for refund which was barred by the Statute of Limitations.

The **Government made the same contention in that case that the taxpayer makes in the case at bar,** namely, that the barred claim for refund could not be off-set against a tax liability and the Government's contention in that respect was sustained. The court held:

> "Plaintiff's facts come so squarely within the terms of these two sections (referring to 3770-3775) when construed together, that **to permit recovery** by way of recoupment, under the facts as disclosed by the record would be **tantamout to judicial repeal of the statutory limitation provisions** enacted by the Congress.
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> "At any rate, the **Congress, in its discretion and within its province, has enacted these provisions. We are not privileged to suspend or apply them at will,** nor to shape them to our notion of the ends of justice."

In **West Virginia Pulp & Paper Co. v. McElligott, 40 F. Supp. 765-771,** the court held:

"The defense of recoupment is available as to all three of plaintiff's actions. Lewis v. Reynolds, 284 U.S. 281, 283, 52 S. Ct. 145, 76 L. Ed. 293; Stone v. White, supra, 301 U.S. page 538, 57 S. Ct. 851, 81 L. Ed. 1265; Routzahn v. Brown, 6 Cir., 95 F. 2d 766, 769. **McEachern v. Rose, 302 U.S. 56,** 58 S. Ct. 84, 82 L. Ed. 46, does not take away the defense of recoupment in the cases at bar. **In that case statutory provisions, Sections 607 and 609 of the 1928 Act, 26 U.S.C.A. Int. Rev. Acts, pages 459, 460, make the defense unavailable.** 'We may assume that, in the circumstances, equitable principles would preclude recovery **in the absence of any statutory provision requiring a different result.'** McEachern v. Rose, supra, 302 U.S. page 59, 58 S. Ct. page 85, 82 L. Ed. 46.

"The taxes sought to be recovered by these suits were **paid long before the enactment of Sections 607 and 609.** It is the policy of Section 609(a) 'to stimulate voluntary payment of taxes by giving the taxpayer an immediate refund right free from the danger that it will be credited against a stale deficiency'."

In **Penn v. Robertson, 29 F. Supp. 386-388,** the court held:

"It is insisted by the Commissioner that the deficiency for the year 1929 should be deducted from the overpayment on the authority of Bull v. United States, 295 U.S. 247, 55 S. Ct. 695, 79 L. Ed. 1421. But the facts of the instant case bring it within the rule announced in McEachern v. Rose, 302 U.S. 56, holding that a tax already barred cannot be off-set against an overpayment."